S. HRG. 98-137

PROPOSED SOLUTIONS TO INTERNATIONAL DEBT PROBLEMS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 502

TO AMEND THE FEDERAL RESERVE ACT TO AUTHORIZE LIMITS ON LOANS TO FOREIGN COUNTRIES, AND FOR OTHER PURPOSES

S. 695

TO AMEND THE BRETTON WOODS AGREEMENTS ACT TO AUTHORIZE CONSENT TO AND AUTHORIZE APPROPRIATIONS FOR AN INCREASE IN THE UNITED STATES QUOTA IN THE INTERNATIONAL MONETARY FUND AND TO AUTHORIZE APPROPRIATIONS FOR INCREASED UNITED STATES PARTICIPATION IN THE IMF'S GENERAL ARRANGEMENTS TO BORROW

APRIL 11, 1983

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MONDAY, APRIL 11, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Mattingly, Hecht, Trible, Proxmire, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

In today's hearing we'll consider regulatory proposals as well as legislation pending before the committee with regard to the international debt situation. The hearing today follows 3 days of hearings in February in which the Subcommittee on International Finance examined in detail the economic and financial implications of U.S. commercial bank loans to foreign governments.

Before we begin it should be noted that some years ago there was considerable concern in the Congress over the capacity of the international financial system to recycle petrodollars and thereby forestall an international economic crisis. That crisis was averted only through concerted action among international lending institutions like the IMF and other foreign lenders and specifically with Government encouragement, U.S. commercial banks. Now that a severe global recession and sharp oil price declines have cut deeply into LDCs' revenues, many are having trouble making payments on loans. IMF resources are strained and many banks have nonperforming loans on their books.

With the benefit of 20–20 hindsight so prevalent in Washington, some suggest that this situation should have been foreseen. After all, oil prices couldn't rise almost exponentially forever. U.S. efforts to restrain high inflation clearly ran the risk of a global recession which would take the wind out of the sails of OPEC and others depending on revenues from oil and other commodities. It is all too easy to say that these conditions should have been anticipated but when the Congress itself can't even accurately estimate its deficit from one month to the next, I'm not sure we're in a position to criticize others for failing to correctly forecast the future in such a complicated area.

Rather than entering into a long debate on the apportionment of blame for this problem, I would hope our attention would be focused instead on solutions. It's clear to this Senator that the administration's proposal to provide an increase in the IMF participation is necessary in order to enable indebted nations to get back on their feet and join in and assist economic recovery.

Contrary to some opinions I have heard expressed, this is not a bank bailout. Rather, what we are doing is assisting a number of developing countries get through a severe liquidity crisis. This is being done by an international agency with no history of default on its loans which exacts very significant financial concessions in return. It is not development assistance. It is short- and medium-term balance of payments assistance.

If these countries are allowed or forced to default on their borrowings, their capacity for future economic growth will be seriously jeopardized. This means reduced U.S. exports to these countries and a significant negative impact on employment here at home.

Is this really what we want to happen? I certainly think not. Because some banks will benefit indirectly from our efforts to assist foreign borrowing nations, we're being asked to exact some kind of retribution on U.S. banks. What kind of punishment are we being asked to administer? One proposal would require the establishment of country loan limits. This would involve either the Congress or the bureaucracy in analyzing economic conditions in over 150 different countries and telling the banks where they can or cannot lend and in what amounts. I doubt if the Government has the expertise to pass judgment on country creditworthiness in such a precise manner.

Should Government lists of bad risk countries become public, as they surely must, that hardly would encourage better relations with the United States on the part of the country which has been blacklisted. More importantly, from a philosophic standpoint, this is no more than Government directed credit allocation in the foreign sector. We have repeatedly rejected this concept in the domestic market. Why should we change our principles when it comes to foreign markets?

This proposal may be an overreaction to the problem. It gives expression to a Washington dictum that I thought had gone out of style with the passing of the Carter administration that an ounce of abuse is worth a ton of regulation. I would have thought that the Bert Lance bill would have taught us a lesson on the dangers of overreacting to a problem. We went far, far beyond what was necessary to take care of that problem, imposed a lot of overly restrictive rules and regulations on everyone involved, and I'm concerned that this is what we may be flirting with now, going far beyond what is necessary to correct a problem, creating additional new problems that we'll have to deal with later.

I would hope that the committee will exercise restraint as we consider the international debt situation and keep in mind that a regulatory solution may be preferable to legislation at this time.

Senator Tower hoped to be here today and was not able to, but in his absence I ask unanimous consent that a statement by him on this particular situation be included in the record.

[Statement by Senator Tower follows:]

STATEMENT BY SENATOR JOHN TOWER ON U.S. PARTICIPATION IN THE INTERNATIONAL MONETARY FUND, AND S. 502, THE INTERNATIONAL LENDING REFORM ACT OF 1983

Senator TOWER. Thank you, Mr. Chairman. I am pleased to have this opportunity to express to the committee and the distinguished witnesses present my views on this matter of economic and political importance.

I intend to support the proposed International Monetary Fund quota increase. With our own economic difficulties, it is tempting to say no—to take the position that it is not our responsibility to bail out either the nations who took on too much debt or the banks that made the loans. However, the issue is not that simple.

The stability of the international financial system is at stake. If nations begin defaulting on large loans, the system could begin to crumble—sending interest rates up around the world and thus effectively ending economic recovery. Additionally, it is not in the best national security interests of the United States to throw these developing nations into financial chaos.

But at the same time, we must correct the causes of the problem so that we do not find ourselves in this same situation again. We in Congress need to look at changes in banking regulations designed to make financial institutions more responsible in making international loans. The IMF must work with the borrowing countries to insure that necessary and complementary changes in trade, fiscal, and monetary policies are made.

The financial difficulties of the developing countries are not abstract topics of interest only to diplomats and bankers. To the people of Texas, the international debt crisis is all too real. The disastrous condition of the Mexican economy brought about by runaway deficit spending and the world recession has brought depression-like conditions to local communities along the 1,952-mile border with Mexico. Business sales in south Texas are off 60 to 80 percent with unemployment averaging in excess of 25 percent.

Town officials in Eagle Pass tell me that half of the labor force is unemployed. With business activity falling and unemployment skyrocketing, the tax base of local communities is rapidly eroding.

In addition, the economic difficulties in Mexico have led to increased illegal immigration to the United States. Illegal border crossings are estimated to have increased nearly 50 percent over the same period a year ago. It is likely that many of these immigrants will settle in Texas, placing even greater burdens on local governments already straining to provide social and educational services to thousands of illegal aliens.

It is my hope that as Congress considers efforts to improve the stability of the international financial system that we remember as well the problems faced by U.S. citizens in the border communities of Texas, California, New Mexico, and Arizona.

I have been pleased with the leadership exercised by the IMF in its development of austerity measures as a condition for extending loans to those countries burdened by the weight of excessive debt. It is the aspect of conditionality that distinguishes IMF loans from much of the well-intentioned but unsuccessful foreign aid extended

in the past to the developing world. It is crucial that the IMF continue its insistence upon fiscal and monetary responsibility.

At the same time, the United States must insist that trade barriers in borrowing countries must be lifted. Some say that Congress and the United States have no leverage with multilateral assistance organizations. I disagree. Because of its 20-percent voting bloc, the United States effectively has veto power over major IMF policy changes. We have a responsibility to citizens of the United States and the world to exercise this power to insure that the conditions of IMF loans make good economic sense.

While the IMF sets out conditional measures in order for a country to qualify for assistance, we in this committee must demand responsibility on the part of our domestic banks involved in lending abroad. In my view, the best regulation, if it is allowed to function, is the free marketplace.

However, in our highly regulated financial system, the free market has only in recent days begun to come into play. Therefore, it is my belief that this committee should review the myriad of legislative and regulatory proposals before us dealing with international lending practices and accounting.

I believe that the positions taken by Chairman Volker, Chairman Isaac, and Comptroller Conover in their proposals to review their regulatory role in our bank's international lending activities have a great deal of merit. Several of these proposals have appeal, while others, in my view, shut the issue of free market discipline completely out of view. The important point here is that we act promptly on the best combination of these measures for the overall benefit of the system.

As we proceed toward markup on this critically important measure, I urge each of my colleagues to review this request with primary consideration not toward PETROBRAS, PEMEX, or the Chase Manhattan, but instead toward the welfare of the American consumer and taxpayer. And I say to you that supporting this quota increase is not inconsistent with these goals.

I welcome our witnesses here today and look forward to their testimony, but before we turn to our distinguished panel of witnesses, I would like to turn to Senator Proxmire for any remarks he may wish to make and then to Senator Heinz.

Senator PROXMIRE. Mr. Chairman, I appreciate that and I appreciate very much you're going to the Democratic side first. I do think on this occasion, in view of the fact that Senator Heinz has done so much work in this area as chairman of the subcommittee, I will defer to him and then I will follow him.

The CHAIRMAN. Thank you, and I did want to follow up what you said that Senator Heinz, as chairman of the International Finance Subcommittee, has spent an incredible amount of time the last 4 or 5 months on this issue. He's worked long and hard and extremely well and I want to compliment him as chairman of that subcommittee for the tremendous amount of work he's put in on a very difficult problem.

I also notice Senator Trible is here. He was hiding under the cameras and I didn't intentionally miss you, Senator, but after Senator Heinz has made any opening remarks he would like to, we'd be happy to hear from you.

Senator TRIBLE. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first of all, I thank you for the kind remarks and want to commend you for calling this hearing and calling this distinguished panel of regulators back before this committee in order to give additional comments on the International Lending Reform Act of 1983 and on any other proposals which have been put forward to deal with the current international debt crisis.

I think that I would agree with you that the purpose of this committee shouldn't be to try and apportion blame as to why things went wrong, but I do think that we have to start with the premise that something has gone wrong with the international financial system, else we wouldn't have this crash program to enact an increase in the authorization for the International Monetary Fund and the General Agreement to Borrow. That is a real authorization for this country, the two together happen to come to close to $8 billion, and we wouldn't be entertaining that legislation, which I support, unless there were a good reason for it.

I suspect the best way to put the problem in perspective is to recognize that our banks in a sense did too good a job of recycling petrodollars with the inevitable result that the structure which was created to fund balance of payments deficits through commercial bank loans had its breakdown in the wake of the 1979 oil price increase.

I personally find it a little odd to have people, including banks, come before us and argue that no one could have predicted that there was going to be some kind of international economic crisis following the 1979 oil price increases. I find it disingenuous because the same thing happened after the 1973 oil price shock and the recession of 1975. There is, therefore, if you will, plenty of blame to go around.

Western governments I think seemed happy to allow the banks to handle recycling with little or no supervision and that goes for our regulators. When Paul Volcker was before the committee some weeks ago he was very candid with the committee and he said, with the benefit of hindsight that he wished he and his fellow regulators had been a little bit more on top of the situation than they had been.

The IMF resources, of course, have been allowed to shrink in relationship to the size of world trade, so our official agencies could not play the role they had played in the past. The LDC governments showed very little concern in some cases for their debt exposure as long as they believed that inflation could continue to cheapen the value of the money used to repay their huge debts, and banks, in spite of all their high-paid economists, made the assumption that oil and other commodity prices would remain high for the indefinite future.

As we all know, all those assumptions, most of them, proved to be incorrect and the pyramid of international debt has come crashing down around the heads of western banks and that really brings us back to the purpose of this hearing.

I think we can all agree that the time period I have just described has not been our regulators finest hour. Bankers in effect pressed their foot down on the lending accelerator with little or no restraint from the regulatory traffic cops. During our previous hearings we found that one bank had more than 100 percent of its capital exposed in just one developing country and that almost every large bank had at least that percentage of risk in two or three LDC's. In a sense, they literally bet the bank on the continued economic health and prosperity of a handful of developing nations.

Although the blame should not be placed solely on the shoulders of the regulators, it's clear that the current debt crisis has been brought on by the failure of our banks to stop at prudential limits and it is the purpose of regulation to determine just how to set and what those prudential limits are. Apparently, the regulators need some additional direction from the Congress to help them set up their rules and limits.

That's what Senator Proxmire and I have attempted to do in our legislation. We are not convinced by the bankers' plea that legislation is totally unnecessary because the market will provide sufficient discipline in the future. We have endeavored to draft legislation which is not punitive—I oppose punitive legislation—which provides the Federal Reserve with the proper mix of flexibility, discretion, and direction. I believe that we have accomplished that, but I'm open to suggestions. I know Senator Proxmire is, too, as to how best to accomplish our goals through other means.

I look forward to the testimony today for just that reason. I would close with this admonition. If there's one thing we've learned from the current debt crisis, it is that we simply can't continue business as usual. I think my colleagues will agree that we cannot go back to our constituents and I doubt we can go to the floor of the Senate to justify an increase in the IMF quota which involves $8.4 billion in budget authority, including the GAB, unless we can also tell them we have passed legislation that will help prevent a recurrence of this, the second debt crisis that we've gotten into internationally involving our banks. Those who suggest that this can be accomplished by simple regulatory adjustments ignore the risk of losing the IMF quota increase to the criticism that we're simply throwing good money after bad with little prospect for reform and no assurance that the situation will not repeat itself 3 years hence.

The CHAIRMAN. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman. Mr. Chairman, these hearings will provide the committee with the views of the bank regulators on how the regulation of foreign lending can be strengthened. This has been a most difficult issue. There have been some disagreements among the regulators over exactly what reforms are needed and how they should be implemented, but despite these disagreements there seems to be a consensus on three crucial points.

First, that our banks have at times been too generous in making overseas loans. Second, that our present regulatory system has not always been effective in restraining improvident foreign lending; and third, that our present regulatory system needs to be strengthened to guard against excessive foreign lending in the future.

I am encouraged that the bank regulators recognize the problem and have come forward with a specific program. As this committee reviews the program I think we must assure ourselves it is adequate to meet the problem. For my own part, I have some real doubts that the regulators' program will do the job.

Our problem, as I see it, is the lack of any statutory base for the strengthened regulatory program. I have no reason to doubt the diligence of our present regulators in carrying out these reforms, but there is no assurance to the Congress that a future set of regulators might not view the matter differently.

Second, the regulators' program does not call for any country lending limits which is an important part of the Heinz-Proxmire bill. I'm not suggesting the country lending limits is the only way to exercise restraint. There may be effective alternatives; for example, capital adequacy standards might be related to the amount of foreign lending by U.S. banks.

The regulators' program does call for a stronger capital standard relating to foreign lending. There does not, however, seem to be any specific procedure or method for putting these standards into effect. Instead, we are left with the present weak system under which the regulators merely recommend standards to the banks.

Another problem is that the loan loss reserve provisions seem little more than a slap on the wrist. The Heinz-Proxmire bill called for reserves whenever a foreign loan cannot be repaid without a substantial restructuring. Under the regulators' proposal, reserves would be required only in cases where there was a protracted period of no payment. Thus, under the regulators' proposal reserves would be required against loans to Zaire but not to Mexico. In the Heinz-Proxmire bill reserves would be required for both.

Mr. Chairman, there are many Members of the House and the Senate who are very reluctant to vote for an additional $8 billion for the IMF and frankly I'm one of them. I don't think we can get the IMF bill through the Congress unless it contains strong safeguards to prevent excessive foreign lending in the future. The bank regulators have made a constructive proposal to provide some safeguards, but I do not think it's enough to assure passage of the legislation. Their recommendations ought to be strengthened and given a statutory base if the IMF legislation is to proceed smoothly in the Senate and House in the months ahead. Thank you.

The CHAIRMAN. Senator Trible.

Senator TRIBLE. Mr. Chairman, I look forward to hearing from the witnesses today so I'll resist the temptation to add another opening statement. I thank you.

The CHAIRMAN. Senator Hecht.

Senator HECHT. I thank you. I want to hear the witnesses, too. Thank you very much.

The CHAIRMAN. Thank you. Before we hear the witnesses, let me just make certain my position is not misunderstood. I do think it is necessary to have some corrective action. My plea in my opening

statement and for several weeks is that we not overreact, that we not go too far. Particularly in the House of Representatives, it's been my observation that some of the talk of provisions over there are simply to satisfy the political end of it to go home and say that we did this and that's why we're able to vote for it. I hope we can come up with a reasonable balanced approach out of this committee that does correct the problem and help with insuring that it does not happen again without overresponding, as I mentioned, as some are doing, particularly on the House side, to the political end of it, and that's why I referred to the Bert Lance bill. There is an example of where there were some abuses that needed legislative correction, but we overresponded to that particular problem and I hope we will not do that this time and we can achieve a middle ground.

Chairman Volcker, would you like to begin?

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, ACCOMPANIED BY J. CHARLES PARTEE, GOVERNOR, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I'll just summarize a few points in my statement, Mr. Chairman.

We have made some progress in dealing with this international financial problem, but we're certainly not through it. There are very heavy pressures remaining and at several places in my statement the point I make is I think approval of the IMF legislation is a key element in dealing with the problem. You've made that case quite eloquently this morning yourself, Mr. Chairman.

I review some of the developments in the international financial world, particularly with respect to some of the major developing countries. We have seen some progress in the Mexican case; some further strong measures have been taken in Brazil. I think those programs are coming along more or less as anticipated. A number of other Latin American countries and countries elsewhere also have come into very difficult and painful external problems and are in various stages of negotiating with the IMF and in many cases with the banks. I think it's quite clear that the extraordinary pressures on the system are not over. I continue to believe they are manageable. We are going to need to manage them if we're going to be successful in the context of world economic recovery, which comes back to our domestic policies and those of other leading countries, but certainly the IMF is a critical force at the middle of this process. It has to provide the leadership and needs enough resources to play its role in the whole process.

The Senate Foreign Relations Committee, as you know, has acted on legislation and added some amendments. Those amendments all seem constructive and desirable to me; I would just mention that briefly.

One of them deals with Federal Reserve membership in the BIS. It's a matter that we've looked at from time to time in the past. We are not formal members of the BIS, but we do work very closely with the BIS on all the matters that affect the evolution of the international financial system. Formal membership involves be-

coming concerned with some of the banking operations of the BIS that we have not been concerned with particularly in the past. There are pros and cons in terms of the Federal Reserve joining the BIS, and we are certainly glad to look at it again and report to the Congress, as that particular amendment suggested.

Another amendment by the Senate parallels some of our own suggestions that the IMF should be concerned with the international debt problem, should be encouraged to intensify its analysis of the debt problem generally and, for individual countries, should strengthen its surveillance procedures. We agree with the thrust of that amendment, and we believe it is constructive.

You have received the joint memorandum that we have all prepared on the regulatory and supervisory side directly, and I won't attempt to review that in detail. Let me just emphasize a couple of points that I think are important.

Our basic premise is that international lending by banks is not contrary to U.S. interests and shouldn't be abruptly curtailed. Banks should maintain adequate financial strength to deal with unexpected contingencies. They should be conscious of the need to diversify risks and avoid undue concentration; that's the thrust of our proposals and that has to be a continuing concern.

But, at this point, we also have to be aware that abrupt action by lenders to withdraw from lending could only be collectively self-defeating and would precipitate financial crises in otherwise creditworthy countries where sound economic policies are in place; it would damage the stability of the international financial system.

We need a sound long-range approach to protect against the possibility of a future crisis, but we also need the flexibility to deal with the present situation. It is that twin goal that our program is designed to meet.

We have laid out a five-point program. I would note that in terms of strengthening the existing examination system which was established in 1979—for the purpose of encouraging diversification, with the purpose of encouraging the concentration of banks and bank directors on that problem, with the intent of encouraging stronger capital among the banks that are carrying on large international lending activities—there are some details that remain to be worked out. We need to specify, a little more than we have done in the joint memorandum, how some of that would be developed. There are difficult questions involved.

Beyond that, we propose some reporting and disclosure measures. We propose specific provisioning measures, guidelines in accounting for front-end fees, and the strengthening of international cooperation.

With the exception of country lending limits, these are all areas that parallel the proposals in the Heinz-Proxmire bill. We do oppose the establishment of country lending limits. We think that if they were based on objective criteria that would be too rigid. If you attempted to implement them on the basis of subjective judgments, you would have a different kind of problem. In any event, there would be extremely difficult transitional problems.

We think we can accomplish the objectives, over time, without those single country limits. We certainly do feel that we can improve our procedures and approaches, that it's important that we

do so. We believe that can be done under existing authority. For that reason, we do not need legislation, and we obviously would oppose legislation we felt was inconsistent or unduly rigid in terms of the purposes that we would like to achieve.

I would also point out that the proposals that we make need the light of congressional and public discussion before they finally take place, and we look forward to that discussion.

The CHAIRMAN. Thank you, Mr. Chairman, and by unanimous consent we will include a copy of the joint memorandum and also the appendixes that go with it covering some of the subjects in greater detail.

[Complete statement and joint memorandum follow:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to appear before this Committee once again to discuss the legislation now before you providing for an increase in the resources of the International Monetary Fund and to discuss related questions concerning the international financial situation and international lending by banks.

During the eight weeks since I last appeared before this Committee to examine these issues, considerable progress has been made in addressing the problems associated with the heavy indebtedness and external financing problems of some of the major international borrowers. However, the international financial system still remains subject to extraordinary pressures. Borrowing countries, the international banking community, the International Monetary Fund, and governments of the lending nations will all need to continue the efforts well started and to build upon the progress that has been made. The Senate Committee on Foreign Relations has acted promptly in reporting out the IMF legislation, and my hope is that this Committee, after due deliberation, will also act favorably on this important matter, critical to the entire effort. In my opinion, the proposed increase in the resources of the IMF remains the key element in a successful strategy of dealing with international financial strains for the short run as well as for the long run.

The federal bank regulators have completed a review of proposals for strengthening supervision and regulation of U.S. banks engaged in international lending. We have submitted to you a "Joint Memorandum" on our proposed program in this area.

In my testimony today I will touch briefly on each of these three areas of recent activity: the international financial situation, the IMF legislation, and our proposals with regard to international lending.

International Financial Situation

During the past two months, further progress has been made in putting into place programs to deal with some of the problems of important borrowing countries that during the closing months of 1982 threatened the stability of the international financial system as well as their own economic prospects. This progress has involved strong actions of the borrowing countries themselves, supported by the IMF, by the international banking community, and in some instances by other governments and central banks.

In the important case of Mexico, the government has been effectively implementing its stabilization program approved by the IMF in late December. Economic activity had, of course, been severely affected by the balance-of-payments and economic pressures before the program could be implemented, and the shortage of foreign exchange has been reflected in a sharp drop in imports and in the current account deficit. But there are also early signs that more fundamental adjustment processes are beginning. Meanwhile, in late March, the first disbursement on the $5 billion bank credit took place, and a large part of earlier official "bridge" financing has been repaid. Other components of Mexico's external financial arrangements — the restructuring of public sector debt maturing from August 1982 to December 1984 and of private sector debt — are proceeding. Despite the decline in oil prices, prospects appear favorable that the adjustment program can be carried through successfully, laying the base for renewed growth.

An important adjustment was made in the Brazilian stabilization program in mid-February when the cruzeiro was devalued sharply on February 18. The net effect should reinforce other measures to move toward external equilibrium, and Brazil, as a major oil importer, will ultimately benefit from the recent decline in oil prices. Meanwhile, banks have completed arrangements to loan new money to Brazil this year; the first drawdown was on March 10. In some respects, the Brazilian adjustment may not be as far advanced -- perhaps in part because the process started later -- and the objective of halving both its current account deficit and budget deficit this year is ambitious. But the Brazilian economy has, of course, great potential, and the challenge can be met.

A number of other countries in Latin American and elsewhere are also grappling with difficult and painful external financial problems and internal imbalances. These countries are in various stages of negotiations with the IMF and lending institutions. Obviously the period of extraordinary liquidity pressures on the international financial system is not over. While the problems are manageable, they will continue to require the skill and patience of all the parties involved. Ultimately, successful evolution will also require a reasonably favorable world economic and financial climate -- a circumstance which emphasizes the importance of policies in the United States and other leading countries. But it is also crystal clear that during this difficult period a great deal depends on the capacity of the IMF to provide leadership, and potentially resources, in the worldwide effort to maintain the kind of financial environment supportive of the needed growth. For that reason, I am gratified that the Senate

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Committee on Foreign Relations has completed its work on the authorizing legislation and that this Committee has moved expeditiously in its consideration.

Progress on the IMF Legislation*/

Three amendments were added by the Committee on Foreign Relations to legislation before you, each of which seems to me constructive. As I understand it, the first amendment essentially clarifies that Congress has to authorize any future changes in the General Arrangements to Borrow (GAB) that would affect the basic terms of U.S. participation or the fundamental structure of the arrangement.

The second amendment would establish the sense of Congress that consideration should be given to membership in the Bank for International Settlements (BIS), an institution that is playing an important role in dealing with the present strains on the financial system, as it has from time to time in the past. The BIS also provides a forum for more or less continuous consultation among central banks, and its role and functioning is of direct interest to the Federal Reserve.

For more than twenty years, the Federal Reserve has regularly participated in meetings at the BIS, including those of the G-10 Central Bank Governors and the Committee on Banking Regulations and Supervisory Practices. We have found this participation very useful but, on balance, have seen no urgent need to be a formal member and assume the seat on the Board of Directors reserved for the governor of the central bank of the United States.

*/ In view of the interest and concerns that have been expressed about the role of the IMF in promoting a liberal international trading system, I have attached an appendix to my statement on this subject.

We would, of course, be glad to examine the matter again consulting not only with the Secretary of the Treasury and the Secretary of State, as provided in amendment, but also with our central banking collegues that are now members of the BIS. In that connection, I would point out that in addition to other considerations formal U.S. membership necessarily would involve some attention to the day-by-day banking operations of the BIS which are not of primary interest to us.

The third amendment to the IMF legislation would establish the sense of Congress that the IMF should strengthen its activities with regard to the collection and dissemination of information on the international borrowing and lending of its members and calls upon the Secretary of the Treasury to instruct the U.S. Executive Director of the Fund to discuss, propose and vote for procedures to increase the IMF's traditional role in this area.

I fully support the thrust of this amendment. As you have noticed, the program for improved supervision and regulation of international lending proposed by the federal bank regulators puts forward similar ideas. We have proposed that not only the IMF try to improve the information flow between borrowers and lenders, but also that the IMF should intensify its analysis for the benefit of members and the public of the trend and volume of international lending and should strengthen its surveillance activities in this area. The surveillance activities of the IMF involve all members — including the U.S. -- whether or not they are currently borrowing from the IMF. The Fund should be encouraged to examine closely members' policies before international financial crises break. These activities are crucial to

the IMF's central role in helping to guide the functioning of the international monetary system, and I believe they are not inconsistent with the general direction in which the IMF has been moving.

International Lending Proposals

Late last week the federal banking regulators distributed to the Senate and House Banking Committe a "Joint Memorandum" with supporting materials outlining a program for improved supervision and regulation of international lending. That package provides a rather complete treatment of our consideration of this important topic, and I will not repeat the analysis here.

I would note the basic premise of the program before you is not that international lending by banks is contrary to the U.S. interest or that it should be abruptly curtailed, but that banks should maintain adequate financial strength to deal with unexpected contingencies and be strongly conscious of the need to diversify risks and avoid undue concentration. Those concerns should be a continuing part of the supervisory effort.

At this particular point, I should also reiterate that abrupt action by lenders to withdraw from lending can only be mutually self-defeating, precipitating financial crises in otherwise creditworthy countries where sound economic policies are in place and damaging the stability of the international financial system. We need a balanced, sound, long-range approach, protecting against the possibility of a future crisis while permitting the flexibility to deal with the present situation. I would point out that, in general, lending in conjunction with IMF programs can be extended without increasing the exposure of the banks in terms of ratios of their loans to capital or assets; in fact, these ratios should decline moderately.

Against this background, the federal banking regulators have designed a five-part integrated program.

1. We propose a strengthening of the country risk examination and evaluation system established in 1979.

2. We propose additional reporting and disclosure designed to provide the public with more current, complete and consistent information about U.S. banks' aggregate exposure to countries and for individual banks where the exposure passes an established threshold.

3. We propose to require banks to make specific provisions -- to the extent that they have not already done so -- against certain country exposures where the country has been unable to service its debt over a protracted period of time and has no prospects of establishing arrangements to do so.

4. We propose to set forth guidelines for the accounting for fees on syndicated international credits, in general requiring spreading of those fees over the life of the credit.

5. We propose a strengthening of international cooperation in two areas. First, we would where possible coordinate our actions with bank supervisors abroad to limit competitive inequalities, to assure equal treatment of lenders and borrowers, and to reinforce the effectiveness of U.S. programs. We also suggest an increased role of the IMF in improving information flows (along the lines of the Committee on Foreign Relations' amendment to the IMF legislation) and strengthening its surveillance over member countries.

You will note that our program does not include the establishment of country lending limits. We concluded that lending limits based upon objective criteria are likely to be entirely too rigid. More or less permanent limits would fail to distinguish between countries capable of carrying substantial debt without significant transfer risk and countries where smaller amounts of debt still raise large transfer risk problems. Lending limits based on subjective judgments that change over time are likely to have capricious and abrupt effects on flows of credit, imply a degree of foresight on the part of the regulators that may not be realistic, be difficult to administer fairly, and involve the impression of politically charged judgments. Moreover, extremely difficult transitional problems would arise in current circumstances.

Finally, we believe the bank regulatory agencies can use, and would plan to use, existing authority, including authority to define and prevent unsafe and unsound banking practices, to implement the program I have outlined. For that reason, legislation along the lines of the Heinz-Proxmire bill does not appear necessary, but I point out, with the exception of the country lending limits provision, our proposals parallel the subject matter of the bill. In view of the technical complexity of some parts of the program and the need to adapt the program in light of experience and economic circumstances, rigid or inconsistent legislative specifications would be undesirable. In any event, before this program is fully implemented we will want to consider comments from the Congress, the banks and the public, as well as from bank supervisors abroad.

Appendix

The Role of the International Monetary Fund in Promoting a Liberal International Trading System

Among the purposes of the International Monetary Fund (IMF) listed in Article I of its Articles of Agreement are the facilitation of "the expansion and balanced growth of international trade" and "the elimination of foreign exchange restrictions which hamper the growth of world trade." Article I also links the temporary provision of financial resources to members "to correct maladjustments in their balance of payments" with the avoidance of "measures destructive of national or international prosperity."

The IMF has two main channels to influence members' policies in this area: conditions associated with financial assistance it provides to members and its regular surveillance activities on the exchange rate and other policies of all members. The IMF has more leverage when a member comes to it for financial assistance; however, the scope for requiring a dramatic dismantling of trade restrictions is limited by the severity of the country's external financial situation. With respect to the use of both channels, the IMF is limited by the requirement that it respect the domestic social and political policies of members. Thus, to the extent that a member's policies adversely affecting the free international flow of goods and services are internal policies or associated with a member's economic system, the IMF understandably finds it more difficult to encourage liberalizing changes. Nevertheless, the IMF has a positive record in this area.

When a member approaches the IMF for financial assistance, it draws up an economic stabilization program. Such programs are often drawn up with the assistance of the Fund staff, but the basic policy decisions are taken

by the political leaders of the country. The purpose of the program is to assist a country to bring about a configuration of its balance of payments considered to be sustainable over time. In this context, what is known as "IMF conditionality" refers to the practice of providing financial assistance only when, in the IMF's judgment, the country involved has formulated and is committed to implementing adjustment policies designed to reestablish a viable balance of payments position. Depending upon the particular circumstances of the individual country, the set of policies designed to achieve this objective is likely to contain measures to restrain aggregate domestic demand (through reducing fiscal deficits and restraining the growth of money and credit), to improve the efficiency of domestic resource allocation and thereby lay the basis for more rapid growth in output over a sustained period (by reducing or eliminating price controls and subsidies, reducing external exchange and payments restrictions, and moving toward the establishment of positive real interest rates), to improve and maintain external competitiveness (through appropriate exchange rate policies), and to foster net capital inflows (through maintenance of an adequate level of interest rates, appropriate exchange rates, and an overall mix of policies that will attract foreign funds and encourage the retention of domestic savings for use in domestic investment).

If successfully implemented, such policies can be expected to bring about adjustment in the balance of payments through a reduction in the current account deficit (i.e., the balance of exports and imports of goods and services) to a level that can be sustained through expected future net inflows of capital on terms compatible with the growth prospects of the

country and without resort to trade and payments restrictions. Such adjustment may, but does not necessarily, entail a temporary reduction of imports. In fact, of the ten largest IMF-supported programs (involving more than SDR 500 million in IMF resources) currently in effect (Argentina, India, Mexico, Pakistan, Turkey, Yugoslavia, Brazil, Chile, Peru, and Romania), the programs for the first six of these, when approved, anticipated an increase in the value of imports in the first year of the program compared with the prior year.

Even in programs that anticipate an initial decline in imports — often cases where the country has been clearly importing more than can be supported by the country's export and external financing capacity —IMF financial assistance and other financing that might not otherwise have become available with an IMF-supported program help to cushion the adjustment process and to avoid an even larger decline in imports that might have otherwise occurred as a consequence of harsher and more abrupt adjustment policies.

One of the standard conditions for making drawings that are phased over the life of an IMF-approved stabilization program is that a member must agree not to impose new, or to intensify existing, exchange and payments restrictions. But the IMF often goes beyond the proscription against imposing further restrictions by actively encouraging members to reduce or eliminate existing restrictions, including, for example, import deposit schemes, bilateral trading arrangements, and external payments arrears. At least three recent programs, those for Argentina, Mexico and Peru, call for significant easing of restrictions of this type. The programs

for Yugoslavia and Romania also involve important reforms of internal pricing practices, bringing these economies close to a market system as we know it. In some cases (for example, in the programs of Pakistan and India approved in 1981 and in Kenya's program this year), liberalization of restrictions on imports constitutes an explicit element in approval of IMF-supported balance-of-payments adjustment programs. The IMF also encourages members to reduce or eliminate subsidies, such as those involving multiple exchange rates, that tend to stimulate exports and/or imports because such subsidies distort resource allocation and contribute to budget deficits.

April 7, 1983

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

As you know, the bank regulators have been working together to review the regulatory framework and supervisory approaches relating to foreign lending by U. S. banks. Enclosed please find a Joint Memorandum on international lending which summarizes our proposals on the subject. Along with the Joint Memorandum are four appendices covering some topics in greater detail.

We appreciate the opportunity for public discussion which Congressional hearings on this subject provide, and we look forward to any further consideration that the Congress and other interested parties put forward. We appreciate the urgency of action in this area in connection with the IMF legislation, and we will, of course, continue to work with you in the effort to improve public policies on foreign lending by U. S. banks.

Sincerely,

C. T. Conover William M. Isaac Paul A. Volcker

Enclosures

IDENTICAL LETTERS SENT TO: CHAIRMAN FERNAND J. ST GERMAIN
CONGRESSMAN CHALMERS P. WYLIE
CHAIRMAN JOHN HEINZ
SENATOR WILLIAM PROXMIRE

April 7, 1983

Joint Memorandum

Subject: Program for Improved Supervision and Regulation of Internationnal Lending

In recent years, the banking systems in the United States and abroad have extended large amounts of credit to foreign borrowers, including foreign governments. As a result of strained economic conditions worldwide, a number of countries, particularly in Latin America, have simultaneously experienced reduced foreign exchange earnings and external financing problems, thus helping to precipitate problems in servicing debt burdens built up over a number of years. As part of the necessary readjustment, many of the major borrowers have adopted economic stabilization programs approved by the IMF and involving, in addition to important domestic measures, both the restructuring of existing bank credits and the extension of a limited amount of new credit. This situation has raised concern that there should be in place strengthened supervisory and regulatory practices aimed at avoiding excessive concentrations of credit in foreign countries.

In response to these problems, the federal bank regulators have reviewed a number of suggestions for strengthening supervision and regulation of United States depository institutions engaged in foreign lending. Some foreign lending (e.g., that to private companies abroad) includes elements of credit risk analogous to domestic lending — elements relating to the capacity and willingness of borrowers to generate resources from operations to repay debts. Lending to foreign governments (i.e., "sovereign lending"), while not entirely free of credit risk, is not subject to the same "market test" of potential insolvency. However, all foreign lending must take account of risks not present in domestic private or public lending, that is "transfer risk." Thus, overall "country exposure" is also a relevant concept for assessing the risks involved in foreign lending.

"Transfer risk" means the possibility that a borrower may not be able to maintain debt servicing in the currency in which the debt is to be paid because of a lack of foreign exchange. A bank's "country exposure" is defined as all cross-border and cross-currency claims and contingent claims on residents of the country, plus other credits guaranteed by residents of the country, less credits guaranteed by residents of other countries and net local currency assets of the bank's offices in the country.

As result of our review of the supervision and regulation of foreign lending, a five-point program has been developed. The objective of the program is to encourage prudent private decision-making in foreign lending that appropriately recognizes the risks while permitting the exercise of lender discretion in the funding of creditworthy borrowers both here and abroad. The proposed procedures reinforce two of the basic principles of sound banking — diversification of risk and maintenance of adequate financial strength to deal with unexpected contingencies. The program will help assure earlier recognition of potential international payments problems, encourage orderly responses to these problems, and provide for stronger reserves to meet adverse conditions when they infrequently, but inevitably, arise.

The five-point program consists of the following elements:

1. Strengthening of the existing program of country risk examination and evaluation;

2. Increased disclosure of banks' country exposures;

3. A system of special reserves;

4. Supervisory rules for accounting for fees; and

5. Strengthening international cooperation with foreign banking regulators and through the International Monetary Fund.

The program constitutes an integrated package — none of the elements alone could accomplish the intended objectives. This memorandum summarizes the principal aspects of the five points. Separate appendices have been attached providing elaboration for some of them.

This program has been designed to create incentives for prudent lending but without establishing arbitrary obstacles to international capital movements or preventing the continuation of credit flows to credit-worthy borrowers. Depending upon particular circumstances, continued capital flows to basically credit-worthy countries in current strained economic conditions remains appropriate — especially in the context of IMF-approved economic stabilization programs — in order to encourage appropriate adjustment by borrowers to their problems, to maintain their capacity to service their outstanding debt, and therefore to preserve the integrity of existing bank assets. These considerations are, of course, not unique to international lending, but the scale of the lending to particular foreign borrowers means that broader considerations of the stability of the international financial and economic system are at stake as well; this fact is reflected in the role of the IMF and other official lending. The five-point program set forth in looking toward the future is designed to recognize these circumstances.

1. Strengthening of Country Risk Examination and Evaluation

As a first step, the federal banking regulators intend to strengthen their present program of country risk examination and evaluation basically established in its present form in 1979. Our review of the operation of this system indicates that increases in banks' country exposure have not in all cases been brought to the attention of high level management as explicitly and forcefully as they probably should have been. This

procedure can be made more effective by establishing clearer guidelines for examiners in formulating exposure warnings and for assuring that these warnings are considered at the policy-making level within bank management. Its more effective use should help to avoid risk concentration and to increase risk diversification.

As a separate part of country risk examination and evaluation, the federal banking regulators will also analyze a bank's capital adequacy in relationship to the level of diversification of the bank's international portfolio. Those institutions with relatively large concentrations of credit in particular countries will be expected to maintain generally higher overall capital ratios than those institutions that are well diversified. As part of this process, the banking regulators will further develop, as a reference point, standards for country exposure concentration as it relates to capital adequacy. Because banks vary in their current capital positions and other elements of risk exposure, the implications for the capital adequacy of any particular bank would have to be evaluated on a case-by-case basis.

In general, the characteristics of a bank's country exposure will be considered a factor to be weighed in the application of the capital adequacy guidelines used by the federal banking agencies. Thus, recommendations on capital levels as a function of country exposure concentrations will form an integral part of the overall supervision and regulation process. In accordance with their recommendations in this regard, the banking regulators will expect appropriate corrective action as necessary to conform to safe and sound banking practices, taking full account of the need for flexibility in some circumstances for responding to needs for additional credit as part of well-considered adjustment programs.

Additional details on the federal bank regulators' development of procedures to strengthen the supervision of country risk are contained in Appendix A.

2. Additional Disclosure

Experience suggests that the identification of increased country exposure and transfer risk based on a subjective analysis of economic factors, particularly in cases of larger countries, may not always take place at a sufficiently early stage so as to make adjustment in banks' lending feasible without jeopardizing service of existing debts or, indeed, disruptions of the financial system more generally. Disclosure triggered by subjective risk evaluation may aggravate the problem. However, more routine disclosure, centered around the concept of concentration, may strengthen other approaches, helping to bring appropriate marketplace discipline to bear on lending decisions.

Depositors and investors, through their individual decisions, will have the information to assess better the prudence of foreign lending and require greater risk diversification and adequate reserves as the condition for their increased deposits and investments in banks' equity and other securities. Banks will need to be prepared to defend policies leading to large and concentrated country exposure as a consequence of their continuing reporting requirements, and indeed considerable movement has been made in that direction by some institutions. The best current practice should be made more uniform. To that end, individual banks should make public disclosure of all concentrations of country exposure that are material.

Another step toward better analysis of developing trends in international lending is more frequent and earlier availability of aggregate data. To this end, reports on material country exposure should be submitted

to the banking supervisors quarterly, instead of semiannually as at present. In this connection, the banking supervisors will require that the reports be submitted more promptly than in the past so that the aggregate information on lending by U.S. banks can be made available to the public on a more current basis.

Additional details on the proposed reporting and disclosure requirements are contained in Appendix B.

3. Special Reserves

Another incentive for risk diversification and increased financial strength can be created through establishment of a system of provisioning against certain country exposures. When a borrower has been unable to service its debts over a protracted period of time, whether or not that borrower is a sovereign, it is appropriate to recognize the risks and the diminshed quality of the assets represented by these loans. Indeed, to the extent interest has not been paid, that by itself diminishes the value of the underlying asset.

It is prudent that the lending institutions establish specific provisions against such assets in order to reflect more accurately the current condition of the asset. Although some banks now make reserve provisions for such purposes, this approach should be more systematic. Such provisions would be deducted from current earnings and, to the extent required by regulation, would not be included in capital for regulatory and accounting purposes. The prospective requirement for reserving, with its attendant bottom-line earnings impact, should act as a cautionary element when the initial decision to lend is being made. Such reserve provisions would not apply to lending to a country where the terms of any restructuring of debt were being met, where interest payments were being made and where

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the borrowing country is complying with the terms of an IMF-approved stabilization program.

Appendix C contains additional details on the proposed reserve provisioning for credits to countries with severe and protracted debt servicing problems.

4. Accounting For Fees

This program element would establish rules for accounting for fees charged in connection with international lending. Some concern has been expressed that so-called front-end fees, when taken into income in the quarter or year in which they are charged, provide an added incentive to seek out international loans in order to boost earnings immediately and, once this has occurred, to sustain past earnings levels. The general practice in the industry is, apparently, to treat a portion of these loan fees -- that part which is paid to all participating lenders -- as interest to be taken into earnings over the maturity of the credit and the remainder -- syndication fees -- as current income. However, specific practice apparently varies, and the more conservative practices may not prevail generally. Therefore, it would be desirable to assure uniform rules so that artifical incentives are not created for foreign lending. To this end, the regulators are prepared to establish rules to require that front-end fees be treated as interest except when they are identifiable as reimbursement of direct costs.

Appendix D contains an analysis of accounting for fees on syndicated international credits and an explanation of the proposed guidelines for such fees.

5. International Cooperation

Present problems in foreign lending are international in scope, and an effective program for limiting the potential scope for such problems in the future must be coordinated with bank supervisors abroad and with the activities and operations of the International Monetary Fund.

Coordination with overseas bank supervisors can help to avoid competitive inequalities, to assure equal treatment of lenders and borrowers, and to reinforce the effectiveness of U.S. programs. The bank regulatory agencies will seek understandings with foreign bank authorities to help achieve the objectives of risk diversification and strengthened financial condition that we have set for ourselves.

Similarly, the IMF can play a major role, particularly with borrowers, in avoiding situations involving excessive build-ups of credit, especially short-term credit. We intend to work in the following areas to improve information flows and to ensure a more effective IMF surveillance process:

1. In its consultations with member governments on their economic policies, the Fund should intensify its examination of the trend and volume of external indebtedness of private and public borrowers in the member country and comment to the country and in its reports to the Executive Board on such borrowing from the viewpoint of its contribution to the economic stability of the borrower. The IMF might also consider the extent or form that these comments might be made available to the international banking community and the public.

2. As part of any member's stabilization program approved by the IMF, the Fund should place limits on public sector external short- and long-term borrowing; and

3. As a part of its Annual Report, and at such times as it may consider desirable, the Fund should publish information on the trend and volume of international lending in the aggregate as it affects the economic situation of lenders, borrowers and the smooth functioning of the international financial system.

Consideration of Lending Limits

The foregoing program does not include the establishment of country lending limits. It was concluded that lending limits based upon objective criteria are likely to be too rigid. Such limits would fail to distinguish between countries capable of carrying substantial debt without significant transfer risk and countries where smaller amounts of debt still raise large transfer risk problems. On the other hand, lending limits based on subjective judgments that change over time are likely to have capricious and abrupt effects on flows of credit, imply a degree of foresight on the part of the regulators that may not be realistic, and be difficult to administer fairly while avoiding political complications. Finally, in view of the substantial exposures already incurred, a program of lending limits would not be workable except with a very long transition period that would tend to vitiate its credibility.

The problem that is before the international financial community today is one of maintaining a reasonable flow of international credit to allow time for orderly adjustment. As for the future, as levels of exposure decrease over time, the program of intensified regulatory surveillance and evalution of country exposures, additional disclosure, special reserves, rules for fee accounting, and improved international cooperation should prove sufficient to deal with build-ups of concentrations of international credit that might threaten a sound banking system.

Implementation Authority

The bank regulatory agencies' authority to define and prevent unsafe and unsound banking practices under their enabling statutes and the Financial Institutions Supervisory Act of 1966 could be used to implement the program outlined above insofar as they require regulatory action. A number of similar measures have been taken in the past utilizing this authority and the courts have generally sustained the banking agency actions. To be effective, the banking agencies must demonstrate a clear link between the established prudential practice and the safety and soundness of depository institutions — a relationship that past experience indicates can be established in the area of international lending. In view of the existence of this authority it would not be desirable to establish rigid or inconsistent legislative rules that could limit the ability of the banking regulators to adapt the program as they gain experience with its implementation and could have the unwarranted and unintended effect of discouraging the international lending necessary to support world trade and economic recovery.

APPENDIX A

PROPOSED REVISIONS TO EXAMINATION PROCEDURES TO STRENGTHEN SUPERVISION OF COUNTRY RISK

In 1979, the bank regulatory agencies put in place new examination procedures for supervising country risk in U. S. bank portfolios. In retrospect, it is clear that these procedures did not have sufficient impact to temper adequately the buildup of concentrations of credit to foreign countries that were potentially vulnerable to external debt service problems. The proposed changes are designed to integrate more fully country risk considerations into the examiners' overall rating of the condition of a bank, to identify problem credits at an earlier stage, to include more specifically transfer risk in the analysis of the adequacy of a bank's capital, and to improve the presentation to a bank's management and directors of concerns of the banking agencies about large concentrations of country exposure.

Changes would be made along the following lines:

(1) New categories will be employed for identifying credits that are not performing because of a country's debt service problems. These categories will replace the traditional classification categories originally designed for evaluating commercial risk, but also currently used for transfer risk, and would more clearly reflect the types of problems that arise due to transfer risk.

(2) Credits in these new categories will be factored into the agencies' evaluation of a bank's asset quality and other measures of financial soundness.

(3) Examiners will be required, under guidelines to be developed, to highlight certain large concentrations of credit in the examination report and in communications with the bank's directors.

(4) Concentrations of country exposure subject to comment will be factored into the evaluation of a bank's capital adequacy. Banks with large concentrations of country exposure will be expected to have extra capital to support those exposures.

(5) Bank managements will be expected to make systematic reports to their boards of directors on country exposures and country conditions.

New Categories for Reflecting Credits Adversely Affected by Transfer Risk

The traditional categories that were originally designed for evaluating commercial risk, i.e., substandard and doubtful, have not proved suitable for evaluating transfer risk. The following categories are designed to reflect more closely the types of problems that arise due to transfer risk.

The new categories and the definitions for each are:

Loss -- Indebtedness considered uncollectible and of such little value that its continuance as a bankable asset is not warranted--for example, repudiated debt. Such indebtedness shall be charged off and no longer be carried on the books of the bank.

Reservable -- This classification would apply when a country had demonstrated protracted debt service problems. Evidence to that effect would include such factors as (a) full interest payments on indebtedness to banks had not been made for more than six months, (b) the terms of restructured indebtedness had not been met for over one year, (c) IMF or other suitable adjustment programs had not been complied with and there is no immediate prospect for such compliance, or (d) no definite prospects exist for the orderly restoration of debt service in the near future.

Debt Service Impaired -- This classification would apply when (a) a country has been unable to meet its external debt service obligations and it has not yet adopted viable policies for restoring its debt service capabilities (or is not in the process of doing so), but is generally making required interest payments, (b) there is no evidence that the country will be able to negotiate a successful rescheduling with its creditors in the near future, and (c) the country has not adopted an IMF or other suitable economic adjustment program or is not adhering adequately to such a program.

Other Changes in Supervisory Procedures

The other changes under active consideration to strengthen supervisory procedures on international lending are: (1) the incorporation into a bank's asset quality rating of credits that fall within the categories just described; (2) the more forceful conveyance in examination reports of concentrations of exposure; and of credits to countries currently experiencing liquidity difficulties that have adjustment programs in place; and (3) the inclusion of concentrations of country exposure in the assessment of capital adequacy.

Implementation of these changes is complex and requires consideration of many technical factors. Details of these changes, including the criteria to be employed and the guidelines to be followed, are as a result still being developed and refined by the banking agencies. In addition, supervisory policies are being developed to insure that boards of directors are adequately reviewing and more fully supervising the international lending policies and decisions of their banks.

APPENDIX B

REPORTING AND PROPOSED DISCLOSURE OF COUNTRY EXPOSURE

Reporting

The federal banking agencies have required U.S. banks since 1977 to file a Country Exposure Report semi-annually for federal supervisory purposes. This report, which is published in aggregate, has proved to be very useful both for the bank supervisors and the banks themselves. Other countries have used it as a model for their own consolidated reporting systems for the country exposure of their banks. The growth of international lending and the increased number of short-term international liquidity problems suggests the desirability of more frequent reporting for supervisory purposes. Therefore, the federal banking agencies propose to require U.S. banks to file the Country Exposure Report quarterly rather than semi-annually, and on a tighter time schedule than is now required. The aggregate data would continue to be published by the supervisors.

Disclosure

Disclosures of concentration of country exposure in U.S. banks need to be more uniform, complete and timely. To this end, the Country Exposure Report (FFIEC Form 009) would be amended to include a disclosure section which the agencies would make available on request. The disclosure section would indicate concentrations of country risk. A sample form is attached. Country exposures exceeding one percent of bank's total assets would be profiled to detail risk. The profile would show exposure on a gross basis and adjusted for third-country guarantees and would show the exposure by sector and maturities. Country exposures between three quarters and one percent of a bank's total assets would also be indicated, but not profiled.

Attachment

REPORT OF CONCENTRATIONS OF TRANSFER RISK

(This report is being collected for public disclosure purposes and will be made available to the public upon request)

A. Exposures Exceeding One Percent of Total Assets

Country	Credit outstanding after mandated adjustments for transfers of exposure (1)	Credit outstanding before adjustments (2)	Distribution of outstandings reported in col. 2					Total commitments to provide credit, after adjustments for guarantees (8)
			To banks (3)	To public sector (4)	To others (5)	Maturing in less than one year (6)	Maturing in more than one year (7)	

B. Exposure Between Three-quarters of One Percent and One Percent of Total Assets

Total number of countries	Credit outstanding after mandated adjustments for transfers of exposure	List Individual Countries

GENERAL INSTRUCTIONS FOR REPORT OF CONCENTRATIONS OF TRANSFER RISK

A. Exposures Exceeding One Percent of Total Assets

The data required for this section must be submitted for each country where "credit outstanding after mandated adjustments for transfers of exposure," exceed 1 percent of a bank's total assets as of the reporting date.

Col 1 - Credit outstanding after mandated adjustments for transfer of exposure. Report the sum of the following columns from the Country Exposure Report ("CER")--Cols. 4-9 + 10-11 + 12 + (18-19 provided greater than 0).

Col 2 - Col 4 of CER
Col 3 - Col 1 of CER
Col 4 - Col 2 of CER
Col 5 - Col 3 of CER
Col 6 - Col 5 of CER
Col 7 - Sum of Cols. 6, 7, & 8 of CER
Col 8 - Cols. 14 + 15-16 + 17 of CER

B. Exposures Between Three-Quarters of One Percent and One Percent of Total Assets

Show in this section the total number of countries in which the bank's "credit outstanding in each country after mandated adjustments for transfers of exposure", as computed above, range between three-quarters of one percent and one percent of total assets as of the reporting date. Also show the aggregate amount of all credit to those countries. Finally, list the names of each country.

APPENDIX C

PROPOSED RESERVE PROVISIONING FOR CREDITS TO COUNTRIES WITH SEVERE AND PROTRACTED DEBT SERVICING PROBLEMS

BACKGROUND

As part of the review of their procedures for supervising transfer risk in U. S. banks, the bank regulatory agencies have examined the methods used by banks to account for loans to countries with severe and protracted external payments problems. In the opinion of the agencies, present procedures do not always reflect the reduced quality of the credits to such countries and there is no uniformity among banks in their accounting for these credits.

Under current procedures, banks are required to review their credits to determine whether all or parts of particular loans should be declared "loss" and charged off or whether additional provisions should be made to the allowance for possible loan losses in light of such credits. This process has not worked well for credits that have been adversely affected due to country risk. In part, this has been because countries, unlike companies, do not declare bankruptcy and there are no established liquidation procedures to provide a valuation basis for such credits. Although some banks have made special provisions to the allowance for possible loan losses because of such credits, the treatment among banks has been uneven, indicating the need for a more systematic approach.

Even though credits to a country, absent repudiation, are not "loss" in the traditional sense, transfer risk problems can seriously impair the liquidity and earning power of an asset. Indeed, to the extent interest has not been paid that, by itself, diminishes the value of the underlying asset. The bank regulatory agencies believe that when the servicing of bank credits has been adversely affected over a protracted period of time due to a country's inability or unwillingness to service its international debts, the net carrying value of the affected assets should be adjusted in a bank's financial statements through charges to earnings and balance sheet provisions.

Since present procedures seem inadequate in this regard, the agencies propose to require banks to make special allocated provisions against certain assets that are found to be severely affected by transfer risk problems. The "allocated transfer risk provisions" (ATRP) would be separate from the general allowance for loan losses and would not be regarded as capital by the agencies. The reserves would be established by a provision against income. In the alternative, a bank would have the option to write off all or part of the loans that are subject to the special reserves and, consequently, reduce the amount of special provisions and reserve balances that would otherwise be required.

In connection with consideration of the special allocated provision proposal, the bank regulatory agencies also reviewed the agreement in 1978 for the examination of transfer risk in U. S. banks. This agreement created an interagency committee, the Interagency Country Exposure Review Committee ("ICERC"), to determine when assets should be classified due to transfer risk, and it provided guidelines to be followed in making those determinations. Experience in applying the procedures indicates a need to clarify and revise the categories and definitions used to identify credits adversely affected by transfer risk. The designation of assets experiencing debt service problems as "substandard" and "doubtful" will no longer be used in characterizing credit problems due to transfer risk. New designations to be used include a category termed "reservable." A "reservable" categorization would trigger the requirement for the ATRP.

An example of the proposed changes in the call report to implement these procedures is attached (Attachment A). A new "provision" item would be added to the balance sheet. The amount of the reserve item would be deducted from "gross loans" to arrive at "net loans." The reserve would be created by a charge ("provision") against income.

PROPOSED PROCEDURES FOR PROVISIONS ON CREDITS TO COUNTRIES CATEGORIZED AS "RESERVABLE"

(1) The new category "reservable" adopted by the banking agencies is defined as follows: A "reservable" categorization is warranted when a country has demonstrated protracted debt service problems. Evidence

to that effect would include such factors as (a) full interest payments on indebtedness to banks had not been made for more than six months, (b) the terms of restructured indebtedness had not been met for over one year, (c) IMF or other suitable adjustment programs had not been complied with and there is no immediate prospect for such compliance, or (d) no definite prospects exist for the orderly restoration of debt service in the near future.

(2) An Allocated Transfer Risk Provision ("ATRP") is required for assets categorized as "reservable." The provisions are to be established by a charge to earnings. The ATRP is to be separate from the general Allowance for Possible Loan Losses and will not be included as part of the bank's capital funds.

(3) No ATRP provisions are required if the bank has already written down the credit by the requisite amount.

(4) Senior executives of the OCC, FRB and FDIC will jointly determine the amount and timing of the provisions after reviewing the report of the ICERC on the "reservable" categorization. The initial provision will normally be 10 percent. The transfer risk will be reviewed annually. Depending on the circumstances, additional reserves may be required. Additional provisions, if warranted, will normally be in 15 percent increments.

(5) The ATRP may be reversed when a credit is no longer categorized as being adversely affected by transfer risk.

(6) Any payment of interest on credits categorized "reservable" should be applied to reduce principal (or credited to ATRP) and not credited to income. The amount of the mandated ATRP may be reduced by the amount of any interest previously applied to principal.

Domestic and Foreign Consolidated Report of Condition of ATTACHMENT A

Legal Title of Bank

at close of business on 19

	Dollar Amount in Thousands	Bil	Mil	Thou	
Assets					
1. Cash and due from depository institutions (From Schedule C, item 8, Column A)					1.
2. U.S. Treasury securities					2.
3. Obligations of other U.S. Government agencies and corporations					3.
4. Obligations of States and political subdivisions in the United States					4.
5. Other bonds, notes, and debentures					5.
6. Federal Reserve stock and corporate stock					6.
7. Trading account securities					7.
8. Federal funds sold and securities purchased under agreements to resell in domestic offices of bank and of its Edge and Agreement subsidiaries					8.
9. a. Loans, Total (excluding unearned income) (From Schedule A, item 10, Column A)					9.a.
b. Less: allowance for possible loan losses					9.b.
Less: Allocated Transfer Risk Provision					
c. Loans, Net					9.c.
10. Lease financing receivables					10.
11. Bank premises, furniture and fixtures, and other assets representing bank premises					11.
12. Real estate owned other than bank premises					12.
13. Investments in unconsolidated subsidiaries and associated companies					13.
14. Customers' liability to this bank on acceptances outstanding					14.
15. Other assets (From Schedule G, item 3)					15.
16. TOTAL ASSETS (sum of items 1 thru 15)					16.
Liabilities					
ITEMS 17 THROUGH 24.a(2). REFER ONLY TO DEPOSITS IN DOMESTIC OFFICES OF THE BANK					
17. Demand deposits of individuals, partnerships, and corporations (From Schedule F, item 1e, Column A)					17.
18. Time and savings deposits of individuals, partnerships, and corporations (From Schedule F, item 1e, Columns B and C)					18.
19. Deposits of United States Government (From Schedule F, item 2, Columns A, B & C)					19.
20. Deposits of States and political subdivisions in the United States (From Schedule F, item 3, Columns A & B & C)					20.
21. Deposits of foreign governments and official institutions (From Schedule F, item 4, Columns A & B & C)					21.
22. Deposits of commercial banks (From Schedule F, items 5 & 6, Columns A & B & C)					22.
23. Certified and officers' checks (From Schedule F, item 7, Column A)					23.
24. a. TOTAL DEPOSITS IN DOMESTIC OFFICES (sum of items 17 thru 23)					24.a.
(1). Total demand deposits (From Schedule F, item 8, Column A)					24.a(1)
(2). Total time and savings deposits (From Schedule F, item 8, Columns B & C)					24.a(2)
b. TOTAL DEPOSITS IN FOREIGN OFFICES AND EDGE AND AGREEMENT SUBSIDIARIES (Schedule F/F, item 8)					24.b.
c. TOTAL DEPOSITS (sum of items 24a and 24b)					24.c.
25. Federal funds purchased and securities sold under agreements to repurchase in domestic offices of bank and of its Edge and Agreement subsidiaries					25.
26. a. Interest-bearing demand notes (note balances) issued to the U.S. Treasury					26.a.
b. Other liabilities for borrowed money					26.b.
27. Mortgage indebtedness and liability for capitalized leases					27.
28. Bank's liability on acceptances executed and outstanding					28.
29. Other liabilities (From Schedule H, item 4)					29.
30. TOTAL LIABILITIES (excluding subordinated notes and debentures) (sum of items 24c thru 29)					30.
31. Subordinated notes and debentures					31.
Equity Capital					
32. Preferred stock a. No. shares outstanding ——— (par value)					32.
33. Common stock a. No. shares authorized ——— b. No. shares outstanding ——— (par value)					33.
34. Surplus					34.
35. Undivided profits					35.
36. Reserve for contingencies and other capital reserves					36.
37. TOTAL EQUITY CAPITAL (sum of items 32 thru 36)					37.
38. TOTAL LIABILITIES AND EQUITY CAPITAL (sum of items 30, 31 and 37)					38.
Memoranda					
1. Amounts outstanding as of report date:					Memo
a(1). Standby letters of credit, total					1.a(1)
(a). To U.S. addressees (domicile)					1.a(1)(a)
(b). To non-U.S. addressees (domicile)					1.a(1)(b)
a(2). Amount of standby letters of credit in Memo item 1a(1) conveyed to others through participations					1.a(2)
b. Time certificates of deposit in denominations of $100,000 or more in domestic offices included in					1.b.

...ending on ..., 19__ ATTACHMENT A

Section A - Sources and Disposition of Income

	Dollar Amount in Thousands	Year-to-date Mil	Thou	
1. OPERATING INCOME:				
a. Interest and fees on loans				1.a
b. Interest on balances with depository institutions				1.b
c. Income on Federal funds sold and securities purchased under agreements to resell in domestic offices of the bank and of its Edge and Agreement subsidiaries				1.c
d. Interest on U.S. Treasury securities				1.d
e. Interest on obligations of other U.S. Government agencies and corporations				1.e
f. Interest on obligations of States and political subdivisions in the U.S.				1.f
g. Interest on other bonds, notes, and debentures				1.g
h. Dividends on stock				1.h
i. Income from lease financing				1.i
j. Income from fiduciary activities				1.j
k. Service charges on deposit accounts in domestic offices				1.k
l. Other service charges, commissions, and fees				1.l
m. Other operating income (from Section D, item 4)				1.m
n. TOTAL OPERATING INCOME (sum of items 1a thru 1m)				1.n
2. OPERATING EXPENSES:				
a. Salaries and employee benefits				2.a
b. Interest on time certificates of deposit of $100,000 or more issued by domestic offices				2.b
c. Interest on deposits in foreign offices				2.c
d. Interest on other deposits				2.d
e. Expense of Federal funds purchased and securities sold under agreements to repurchase in domestic offices of the bank and of its Edge and Agreement subsidiaries				2.e
f. (1) Interest on demand notes (note balances) issued to the U.S. Treasury				2.f
(2) Interest on other borrowed money				2.f
g. Interest on subordinated notes and debentures				2.g
h. (1) Occupancy expense of bank premises, Gross				2.h
(2) Less: Rental income				2.h
(3) Occupancy expense of bank premises, Net				2.h
i. Furniture and equipment expense				2.i
j. Provision for possible loan losses (from Section C, item 4)				2.j
Provision for Allocated Transfer Risk				
k. Other operating expenses (from Section E, item 3)				2.k
l. TOTAL OPERATING EXPENSES (sum of items 2a thru 2k)				2.l
3. INCOME BEFORE INCOME TAXES AND SECURITIES GAINS OR LOSSES (item 1n minus 2l)				3.
4. APPLICABLE INCOME TAXES				4.
5. INCOME BEFORE SECURITIES GAINS OR LOSSES (item 3 minus 4)				5
6. a. SECURITIES GAINS (losses), GROSS				6.a
b. APPLICABLE INCOME TAXES				6.b
c. SECURITIES GAINS (losses), NET				6.c
7. NET INCOME (item 5 plus or minus 6c)				7.
OR				
7. INCOME BEFORE EXTRAORDINARY ITEMS				7.
8. EXTRAORDINARY ITEMS, NET OF TAX EFFECT (From Section F, item 2z)				8.
9. NET INCOME (item 7 plus or minus 8)				9.

APPENDIX D

PROPOSED SUPERVISORY GUIDELINES FOR ACCOUNTING FOR FEES ON SYNDICATED INTERNATIONAL CREDITS

A. Description of types of fees and recent practices

In addition to the stated interest on international syndicated[1/] loans (including stated interest adjustments for late payments), banks often require payment of certain fees in connection with these credits. These fees are identified by a variety of terms, and are intended for a variety of purposes: for example, a flat fee added specifically to increase the yield of the loan; a fee designed to cover costs associated with syndicating a loan (e.g., for structuring and negotiating a loan package, underwriting a syndicated loan, advising the borrower); a fee to cover the costs of committing funds on the prescribed terms for a fixed period of time; or a fee for serving as agent in administering a syndicated credit. In addition, banks frequently provide in the loan agreement that the managing bank(s) is to be reimbursed for all out-of-pocket expenses incidental to the arrangement of a credit facility, as well as collection or enforcement costs. (A glossary of terminology and description of the principal fees associated with the extension of international credits by commercial banks is attached.)

A survey of a sample of international syndicated loan agreements, concluded between 1978 and 1983, for borrowers in those countries recently experiencing balance of payments difficulties indicates the following:

1/ "Syndication" is the process of arranging a Multi-bank Credit Facility and is characterized by the formation of a Management Group, assumption of "Underwriting Commitments" and participation of various Lending Banks.

-- Over this period, commitment fees have ranged generally between 1/4 to 1/2 percent on the undrawn amounts of the loan during the availability period. Agency fees have varied for example from $7,500 per year to $300,000, with the variations perhaps related to the size and complexity of the loans. Practically all the agreements surveyed had detailed provisions relating to reimbursement of expenses.

-- The stated interest rates on the loans surveyed by-and-large ranged around 1% to 1-5/8% above LIBOR, with only a few notable exceptions.

-- Management and other front-end fees were unstated in the loan documents in the majority of cases, with the fees established by a side agreement. It is not clear the extent to which these fees are disclosed to other participants in the syndicate. Where the front-end fees were stated, they ranged from 3/4% to 1-1/2%.

B. Current accounting rules and practices applicable to nonrefundable fees

We understand that there are differences in the manner in which banks account for the nonrefundable fees associated with international loans. The major difference is the extent to which the fees are amortized over the life of the loan, as an adjustment to the interest yield on the loan, or instead are taken into income at the time the fees are received. Currently, neither generally accepted accounting principles nor regulatory policy definitively specify the manner in which fee income to the bank should be recognized.

Existing guidance on the timing of recognition of revenues is provided in Accounting Principles Board (APB) Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises that states the following realization principle:

> Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used.

Thus, under these accounting principles, each activity for which nonrefundable fees are received must be analyzed to consider whether the activity provides services and constitutes a separate earning process or is an integral part of the entity's central operations.

The American Institute of Certified Public Accountants (AICPA) Industry Audit Guide, Audits of Banks ("Bank Audit Guide") (1983) at pages 52-55, provides very general guidance as to accounting recognition of fees. As to commitment fees, the Bank Audit Guide in part states:

> "Banks have recorded income from commitment fees in a variety of ways including recognition:
>
> (a) in full when received.
> (b) when the commitment period has expired or the loan has been drawn down.
> (c) ratably over the commitment period.
> (d) ratably over the combined commitment and loan period.
>
> "The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. However, a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan in relation to the outstanding balance.
>
> "Fees representing compensation for a binding commitment or for rendering a service in issuing the commitment should be deferred and amortized over the commitment period using the straight-line method."

The Guide does not directly address questions of front-end fees in syndicated international credits, but discusses "origination fees" as follows:

> "Banks also receive fees for originating loans in-house. The normal origination fee (generally referred to as points) is essentially a reimbursement for the expenses of the underwriting process, that is, processing the loan application, reviewing legal title to the collateral, obtaining appraisals, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized as income at the time of loan closing. Loan origination fees that are not reimbursements of such costs should be amortized to income over the expected loan period by application of the interest method."

Thus, existing accounting principles allow for a substantial exercise of discretion and so disparity in practice for accounting for front-end and other fees associated with syndicated international credits. Indeed, the accounting profession has recognized that clearer guidance is needed with respect to accounting for nonrefundable fees by financial institutions on all forms of credits. The AICPA has, for this reason, formed a task force to prepare an issues paper addressing the diversity in accounting practice. The study has been underway for several months and no recommendations have as yet been made.

C. Proposed supervisory guidelines for accounting for fees on syndicated international credits

There has developed an increased use of fees to cover a number of different purposes including additions to the yield of international syndicated credits. In view of the present diversity in accounting practice as to those fees among banks, and paucity of definitive guidance as to the appropriate accounting for the wide range of fees that has developed, the federal bank regulatory agencies consider that to achieve conformity and uniformity in accounting for fees the following guidelines should be established.

PROPOSED GUIDELINES

1. Front-end fees in most instances represent an adjustment to the interest yield and shall be deferred until the loan is issued, and then amortized over the expected life of the loan in relation to the outstanding loan balance using the interest method. Front-end fees, or the portion thereof, that are identifiable as reimbursement of direct costs shall be recognized as income at the time of the loan closing or restructuring.

2. Fees for guaranteeing the funding of a loan (i.e., commitment fees) shall be recognized as revenue over the combined commitment and loan period. Reimbursement of any direct loan processing costs will be recognized as income at closing. Then the straight line method, based on the combined life of the commitment and loan period, shall be applied to the remaining fee to recognize income during the commitment period. When the loan is disbursed, the interest method shall be applied to the balance of the fee to recognize income over the life of the loan. If the loan in fact is not funded, unamortized commitment fees will be recognized as income at the end of the commitment period.

3. Agency fees and advisory fees should be recorded as income when received to the extent they represent reimbursements for identifiable, direct costs, otherwise they should be amortized over the expected period of the loan.

COMMENTARY

A. In a syndicated credit, it is often difficult to determine what share of the front-end fees represent a reimbursement of direct costs of the Managing Bank(s) and what share represents an adjustment to the interest

yield. A reasonable presumption is that a Managing Bank should recognize a portion of the fee as an adjustment to interest yield based upon the other Participating Banks' share of the fee. Hence, it may be appropriate to consider the portion equal to the largest of any Participating Bank's*/ share of the front-end fee as an interest yield adjustment. The balance of a Managing Bank's share of a front-end fee, or some portion thereof, may be considered as reimbursement of direct costs if such costs are identifiable.

B. Proposed Guideline #2 reflects a presumption that commitment fees often embody three elements -- reimbursement of direct processing costs, remuneration from services in making commitments (such as assumption of risk of adverse changes in market interest rates over the commitment period), and a component that represents a yield adjustment. Determining the amount of each component may be difficult. When the separate components of the fees cannot reasonably be identified, the foregoing guideline provides a reasonable solution for recognizing the total fees over the combined commitment and expected loan period, and is the approach currently recommended in the Bank Audit Guide. The guideline also presumes that it is difficult to determine at the outset of a loan whether the loan in fact will need to be funded. Accordingly, a commitment fee should be accounted for over the combined life unless the loan is not actually funded.

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*/ A "Participating Bank" is not included in the Management Group for the credit nor does it assume any underwriting risk, i.e., the bank does not commit to lending obligations in excess of the amount it intends to lend in the transaction.

Glossary of Fees

1. Front End Fee: A flat fee paid by the Borrower to the Lending Bank(s). The fee is generally expressed as a percentage of the amount of the Credit Facility and is paid on the signing or disbursement dates of the Credit Facility. This fee is also sometimes referred to as a commission, financing fee, or flat fee.

   a. Management Fee: The portion of the Front End Fee which is distributed to Lending Banks (in a Multi-bank Credit Facility) in differing amounts depending on their roles in the transaction (i.e. Managing Bank, "Underwriting Bank," Participant, etc.) and participation amount. Managing Banks normally receive a larger share of the Front End Fee than do Participants. There are numerous alternatives for payment of the Management Fee to accomplish different structure and pricing objectives. The Management Fee normally represents an interest yield paid in fee form and, in the case of Multi-bank Credit facilities, frequently includes an element of compensation for additional service provided or "underwriting risk" assumed.

   b. Praecipuum: The portion of the Front End Fee which is distributed to one or more of the Lending Banks (generally Managing Banks) in a Multi-bank Credit Facility. This allocation of the Front End Fee serves as compensation for handling a disproportioniate share of the responsibility for arranging a Credit Facility or assuming an underwriting risk.

c. Pool: The residual amount resulting from the payment of Participating Banks in Multi-bank Credit Facilities of a less than full share of the Front End Fee. The Pool amount, which may or may not exceed the Praecipuum, is normally apportioned among Managing Banks on some preagreed upon formula and represents a form of compensation for the additional service provided by the Managing Bank(s) during the arrangement of the transaction.

2. Agency Fee: An annual fee paid to the Agent Bank by the Borrower and is normally intended to reimburse the Agent Bank for out-of-pocket expenses incurred in the performance of its administrative duties. Such expenses normally include telex, telephone, postage, printing, and travel. The amount of Agency Fee is generally fixed at the time of the signing of the Credit Agreement and varies in amount depending upon the number of Lending Banks participating in the Credit Facility, the complexity of the transaction and the frequency of communication with the Lending Banks.

3. Commitment Fee: This fee is paid by the Borrower and compensates Lending Banks for legally committing to lend to a Borrower at agreed upon terms and conditions at some future time. This fee is sometimes referred to as a Reservation Fee. This annual fee is customarily expressed as a percentage of the unused commitment from the Lending Bank and is normally paid quarterly in arrears.

4. Advisory Fee: A fee paid by a Borrower to compensate a bank(s) for a specific advisory service provided in relation to a transaction, such as a complex project loan. The advice may relate to the structure of the transaction or its arrangement and execution. This fee often is not listed in the loan agreement.

5. Expense Reimbursement: It is customary for a Borrower to reimburse banks active in arranging multi-bank or direct (i.e. one-bank) Credit Facilities for out-of-pocket expenses incidental to the arrangement of such facility. Normally these expenses include legal, telecommunications, travel and other expenses incurred during the arrangement of the Credit Facility and collection or enforcement costs.

The CHAIRMAN. Mr. Conover.

STATEMENT OF C. TODD CONOVER, COMPTROLLER OF THE CURRENCY

[Complete statement follows:]

STATEMENT OF C. T. CONOVER
COMPTROLLER OF THE CURRENCY
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
APRIL 11, 1983

Mr. Chairman and members of the committee, I am pleased to offer my views on the international financial situation, the importance of additional funding to the IMF, and supervision of international lending. I will begin my remarks today with a brief description of the problems in international lending and then discuss some possible actions to address those problems.

INTERNATIONAL FINANCIAL SITUATION

In my testimony before the Senate Subcommittee on International Finance and Monetary Policy on February 17, I reviewed how the present international lending problems developed. Rather than repeat that chronology today, let me simply state the problem. A number of debtor countries have failed to make the necessary adjustments to rapidly changing economic conditions and, as a result, are having temporary difficulties making payments on their external loans.

Many U.S. banks have large exposures to these countries that have become high risks. Several U.S. banks have aggregate exposures exceeding 50 percent of capital to public and private sector borrowers in Mexico, Brazil, and/or Argentina.

In dealing with this problem we must strike a balance between long- and short-term considerations. Over the long term, we must achieve greater discipline in international lending. But, in doing so, we must make certain that our actions do not precipitate the very crisis we are seeking to avoid. We cannot cut off international credit flows, or we will restrict international trade, compound the economic problems now facing borrower countries, and contribute to social and political unrest. Therefore, our actions must not result in an immediate reduction in international lending. Instead, for the short term, the risk inherent in the existing exposure must be reduced -- that is, the borrowing countries must be restored to economic health.

ADDITIONAL FUNDING FOR THE IMF

The liquidity and economic problems can only be solved through collective action by all the affected parties: multilateral institutions, western governments, commercial banks, and borrower nations. I support the collective financial assistance that has been recently provided.

The International Monetary Fund (IMF) has played a central role in this assistance. The IMF provides hard currencies which member nations may borrow. As a condition for IMF assistance, borrowing countries must agree to carry out programs designed to restore their economic health. These programs are also the basis for debt restructuring arrangements and for the extension of new credit to countries with debt problems. Each dollar of IMF resources can attract several additional dollars in private and official support for a borrower nation. It is therefore vital that the IMF continue to have funds available for countries experiencing financial difficulties. Given the Fund's existing commitments and the likely additional demands upon its resources in the future, the proposed increase in IMF funding is essential to maintaining the stability of the world-wide financial system. I strongly support such an increase.

SUPERVISION OF INTERNATIONAL LENDING

In the future, developing countries will continue to need additional bank credit. And banks will have an equally important need to avoid excessive international exposures.

International loans carry a degree of risk in addition to traditional commercial credit risk. Sovereign loans to foreign

governments are not subject to conventional market tests for potential insolvency. When loans are made in one country and denominated in the currency of another country, they are subject to "transfer" risk. That is, the country may not be able to generate adequate foreign exchange to make loan payments.

In my testimony on February 17, I explained in detail how we supervise international lending. I also suggested areas that we believed required strengthening. Since that time, we have been working with the Federal Reserve and FDIC to develop a way to strengthen supervision of international lending. A joint memorandum outlining a five-point program was provided to the Committee last week. Let me summarize it for you.

The objective of the program is to encourage the banks to make prudent international lending decisions. It is based on two fundamental principles of banking -- diversification of risk and the maintenance of adequate financial strength to deal with contingencies. The program promotes earlier recognition of international lending problems, encourages orderly responses to these problems, and provides for stronger reserves should severe problem loans develop. The program is an integrated package -- all elements are necessary to accomplish the objective.

The program elements are:

1. Strengthening of Country Risk Examinaton and Evaluation. The federal banking agencies must strengthen the Interagency Country Exposure Review Committee (ICERC) process which I explained at length in my testimony on February 17.

a. Get Management's Attention. In some cases, supervisory concerns about country risk and exposure levels have not been clearly communicated to the highest levels of a bank. We intend to correct this problem by stating our concerns more explicitly and by highlighting those concerns more forcefully in our Reports of Examinations, transmittal letters, and meetings with Boards of Directors.

b. Strengthen Capital Requirements. If a bank decides to carry relatively large concentrations of exposure in a particular country, the regulatory agencies will expect those banks to maintain a higher level of capital.

2. Additional Reporting and Disclosure. To meet supervisory needs, the banking agencies propose that banks report their transfer risks quarterly instead of semi-annually. Although this reporting would impose an additional burden on banks, such information is necessary to better monitor international exposures.

The money and capital markets also need more frequent, uniform, and detailed information about the international exposures of U.S. banks. Therefore, such information should be made available to the public.

3. Prudential Reserves For Problem Loans. Some U.S. banks are not realistically recognizing the value of foreign loans with protracted repayment difficulties. We believe banks should adjust the value of such assets, rather than carrying them on their books at full value. For that reason, the banking agencies propose to establish a reserve policy for the uniform treatment of such loans.

Under such a policy, special reserves would be established for loans on which the borrower has demonstrated protracted debt service problems. Evidence to that effect would include such factors as (a) full interest payments had not been made for more than six months, (b) the terms of rescheduling agreements had not been met for over one year, (c) IMF programs had not been complied with and there is no immediate prospect for such compliance, or (d) no definite prospects exist for the orderly restoration of debt service. The reserve would be charged against income in an amount to be determined by the bank regulatory agencies each year.

4. Changes in Accounting For Fee Income. Neither generally accepted accounting principles nor regulatory reporting requirements specify how loan fees should be recognized as income. For that reason, the banking agencies are prepared to establish rules to require banks to more realistically recognize fee income.

Fees received in conjunction with international credits, including reschedulings, typically represent both expense reimbursements and interest yield adjustments. The only portion of a fee that should be taken into current income should be those amounts that represent costs directly incurred in putting the loan together. Otherwise, current income may be distorted and an inappropriate incentive to lend is maintained.

5. Stronger Cooperation With Foreign Bank Supervisors and IMF. The interdependence of the international financial system requires the coordination of our efforts with those of bank supervisors in other countries, as well as with the IMF. Such coordination can reduce competitive inequities by ensuring uniform treatment of all international lenders. It will also increase the effectiveness of our efforts with U.S. banks.

The IMF can play an important role in strengthening overall supervision of international credit. The Fund has access to data on all the external borrowing of its member countries. Therefore, it could help banks and their supervisors by publishing more international lending information and by placing limits on public sector borrowing of countries undertaking IMF programs.

* * * *

Mr. Chairman, that concludes my prepared statement. I will be happy to answer any questions.

20-624 O—83——5

The CHAIRMAN. Thank you. Chairman Isaac.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman. In view of the completeness of the statements by Chairman Volcker and Comptroller Conover, I'll be very brief and just summarize my statement.

We testified on February 17 in favor of the IMF legislation. We noted at the time that the international loan problem was due largely to a lack of discipline on the part of governments around the world in the conduct of their fiscal and monetary policies, and on the part of banks throughout the world, including our own.

We think a number of measures need to be taken and should be taken to strengthen the discipline in the banking system. In the next week or two we will be submitting to the Congress a report required under the Garn-St Germain Act with respect to the deposit insurance system. We feel strongly that until market participants—large depositors and other major funds suppliers—come to understand that their positions are not 100 percent protected by the Federal Government, in the case of the failure of a large bank, marketplace discipline will be inadequate.

When we do submit this study, and I don't want to dwell on all the specifics, we hope it receives careful attention by the Congress because we think it's critically important to restoring discipline in our banking system.

We have developed, on an interagency basis, a number of suggestions to deal with the current international loan situation. They deal with disclosure requirements, the accounting treatment of fee income, prudential reserves, and country lending limits.

We are in agreement on all of those subjects—that is, we favor increased disclosure; we favor a new treatment of fee income to reduce the incentive for banks to create new foreign loans in order to boost current income; we favor the creation of prudential reserves on loans to certain countries where repayment is in serious jeopardy; and we are uniform in opposing the imposition of country lending limits.

In addition, though, we at the FDIC are exploring to diversification reserves—that is, requiring banks in effect to maintain higher equity capital positions when those banks choose to concentrate their foreign lending exposures. We understand a bill has been drafted that would require a minimum capital base for all banks. Although we would have several suggestions for improvement in this bill and would strongly object to banks being singled out from other very similar, insured financial institutions—in particular savings and loan associations—we are interested in the concept of the minimum capital standard. Such a requirement would add significance to mandated diversification reserves since amounts taken from capital to establish our reserve would presumably have to be replaced if the statutory minimum were violated.

Thank you, Mr. Chairman and members of the committee, for the opportunity to appear. I will be pleased to answer any questions.

[Complete statement follows:]

STATEMENT

BY

WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, I am pleased to have an opportunity to present the FDIC's views on S. 502, the International Lending Reform Act of 1983 and on the regulation of foreign lending activities of American banks.

On February 17, 1983, I appeared before the Subcommittee on International Finance and Monetary Policy to discuss the international and domestic implications of U.S. commercial bank lending to foreign governments and corporations. The Subcommittee members made it clear they believed we should make some changes in our policies and practices in order to impose some discipline on the international lending activities of our banks to avoid a recurrence of the current dilemma. We concur in that view. The only real questions are how much restraint is required and how will the discipline be imposed. We are of the view -- for a variety of reasons which we discussed that day -- that the greater marketplace discipline must be brought to bear on bank risk-taking.

As I testified on February 17, we feel that until market participants, such as large depositors and other major funds suppliers, come to understand that their position is not 100% protected by the Federal government in the case of a large bank, marketplace discipline will be inadequate. We will soon submit a study to Congress which outlines our proposals for changing the manner in which we handle bank failures. While I will not dwell on the specifics of those proposals, I would report to you here that we consider those plans an integral part of any program to impose market discipline.

With respect to international lending activities of American banks, there are several areas in which we are prepared to act by regulation. With one exception, country lending limits, they track closely the thrust of S. 502. They involve disclosure of foreign exposures, accounting for fees, and the establishment of prudential reserves against certain foreign debts.

DISCLOSURE REQUIREMENTS

At present, certain banks are required to report semiannually on their foreign lending activities. This report, the Country Exposure Lending Survey, is used by regulators to track lending patterns of American banks. Two problems exist in this system. First, the data are not reported in a timely enough manner. We are working on a proposal to increase the reporting of these data to quarterly in an effort to eliminate this problem.

The second, and perhaps more important, drawback of the system is that none of the information we collect is available to the public on an individual bank basis. If the market is to assist us in imposing discipline, it must have timely information. We, therefore, are working on a proposal to make certain of the information in the Country Lending Survey publicly available. In general, we are thinking along the lines of making available information on bank exposures to countries where those exposures exceed a specified percentage of a bank's total assets. This is not too dissimilar from the SEC's reporting requirements, except that we would not limit the disclosure to those countries

experiencing "liquidity problems." By requiring banks to report exposures in all countries where the exposures exceed one percent of total assets, we would allow the marketplace to judge the extent and nature of the risk in a bank's international loan portfolio.

FEE INCOME

The level of international lending and increased incidence of reschedulings over the past two years has provided many banks with substantial income in the form of front-end fees. Those fees are often taken into income in the period a loan is made, providing a boost to current earnings. A more realistic approach, particularly for rescheduled debt, would have that portion of the fee used to increase the yield on the loan taken into income over the life of the loan. We propose that all such fees not identifiable as reimbursement for out-of-pocket administrative costs be amortized over the life of the loan. This would discourage banks from originating or rescheduling loans merely to boost current earnings or sustain past earnings levels.

PRUDENTIAL RESERVES

The third area of concern relates to how problem foreign loans are carried on the bank's books. There has been much criticism of the regulators' failure to force banks to write down international loans which appear marginal to many observers. A very valid question

arises as to whether their failure to do so results in a misrepresentation of the banks' true condition. It seems obvious that the full collection of certain foreign loans is in serious doubt, and we believe prudential reserves for those loans should be established. Our proposal is that such reserves be established out of the income stream, and we intend to require them. Moreover, these reserves will not be included in our definition of capital for purposes of capital adequacy calculations, as is the traditional reserve for bad debts.

LENDING LIMITS

We have given a great deal of thought to the notion of country lending limits and have concluded they would be highly inappropriate. Lending limits based on objective criteria are likely to be too rigid. Such limits would fail to distinguish between countries capable of carrying substantial debt without significant risk and countries where smaller amounts of debt pose great risk. Limits based on subjective criteria that change over time are likely to have abrupt effects on credit flows, imply a degree of foresight on the part of regulators that may be unrealistic, and be difficult to administer while avoiding political complications. Finally, in view of the already substantial exposures in many banks, a program of lending limits would need a very long transition period that would tend to vitiate its credibility.

DIVERSIFICATION RESERVES

An additional area we at the FDIC are exploring is that of diversification reserves -- that is, requiring banks to in effect

maintain higher equity capital positions when those banks choose to concentrate their foreign lending activities. We understand a bill has been drafted that would require a minimum capital base for all banks. Although we would have several suggestions for improvements in the bill, we would strongly object to banks being singled out from other very similar, insured financial institutions -- in particular, savings and loan associations -- we are interested in the concept of a minimum capital standard. Such a requirement would add significance to mandated diversification reserves, since amounts taken from capital to establish our reserve presumably would have to be replaced if the statutory minimum were violated.

Thank you Mr. Chairman and members of the Committee. I will be pleased to respond to any questions you may have.

The CHAIRMAN. Thank you, gentlemen. In addition to your joint memorandum being included in the record in full, we will also place each of your statements in the record in full.

Chairman Volcker, is it correct that none of the Latin American countries that have been experiencing debt service problems would be reservable under your proposal?

Mr. VOLCKER. I think that's correct at this point. If they ran into extended difficulties and were not able to keep up with their interest payments, or fell out of compliance with Fund programs or a variety of other criteria, they potentially could be. But it's correct, as I see it, that none of them would be subject to reserves now.

The CHAIRMAN. Well, would your proposal lead to any different regulatory treatment of those banks that have heavily loaned in those Latin American countries experiencing debt service problems today? If they're reservable now, would it have a different treatment for them?

Mr. VOLCKER. Any lending activity would be affected by the fee proposals, by the disclosure proposals, if they qualified in those particular instances. They would also be dealt with, as indeed they are now, under the examination system, which is in effect being tightened up. They would be commented upon. Those exposures would be noted; conclusions would be drawn from those exposures in a general way with respect to the capital positions of the banks.

Some of those approaches remain to be worked out in detail. Very difficult questions arise as to precisely the criteria to be used, for instance, in drawing conclusions as to the bank's capital position, but that is definitely contemplated. Those exposures, in cases where they are large—which they obviously are in some Latin American cases—would have implications for the judgments of the various regulators about a bank's capital position.

The CHAIRMAN. Possibly requiring more capital?

Mr. VOLCKER. Yes.

The CHAIRMAN. What would be the result of requiring special reserves against all loans to any country that had to restructure its debt?

Mr. VOLCKER. It seems too sweeping to me. There have been a great many debt restructurings in the international area recently. Not every debt restructuring involves, in my judgment, the kind of conditions that should require substantial reserving. It's a matter of judgment as to what amounts would be appropriate, but I, myself, could not see the reason for a general requirement for reserving against every restructuring.

The CHAIRMAN. Your proposal calls for a strengthening of country risk examination and evaluation. A lot of people feel that many banks that have gotten involved in this foreign lending simply do not have the expertise to do so. To what extent would your proposal examine expertise and ability to be involved in this?

Mr. VOLCKER. Our present examination approach presumably does that. Whether it's done it as well as it should have, in the light of hindsight, I don't know; but that was certainly a key provision of the examination system that was introduced in 1979.

EVALUATING BORROWING EXPERTISE

The first thing that is looked at is what kind of a system do you have in your bank for evaluating borrowing exposure. If you don't have some expertise, you don't have a system. If you don't have a way of evaluating appropriate country lending limits, you should be criticized. That is in our basic examination approach. I think I can speak for all the supervisors; we follow a uniform approach in this respect. Whether we've done it effectively enough, I don't know. That's an area to review; the consideration you raise is certainly very relevant and should have been in place all along.

The CHAIRMAN. Would you agree that there are a lot of banks that have gotten involved who simply do not have the expertise? We're not talking about the big banks. A lot of people don't realize that there's some 1,500 banks that have been involved in foreign lending that certainly don't have the departments like Chase and Citicorp and Bank America and all of those. So if you examine expertise, has it been a giant sieve?

Mr. VOLCKER. I would like to think not. I suppose we can all make mistakes in very sophisticated ways. Some of the banks with the most elaborate systems may have found that's not absolute insurance against a mistake. We have a rather elaborate examination system for looking at that exact point but whether we've caught it adequately or not is a question.

The CHAIRMAN. Chairman Isaac, do you have any comments on this subject?

Mr. ISAAC. Some banks are involved in the international area that shouldn't be, but we have tried ——

The CHAIRMAN. Well, we're agreed on that. My question is more direct of why, if we're examining expertise, and in your proposals, does this mean a much tighter evaluation of expertise?

Mr. ISAAC. We are looking at, and have always looked at, expertise and have tried to either move banks out of this area or to strengthen their management where we've found that there has been a lack of expertise. The number in Mexico is probably somewhat larger than it would otherwise be because of the number of smaller banks in the Southwestern region of the country that are doing business in Mexico on a rather natural basis. It's their backyard. I believe that the number of banks involved in other countries further away is significantly lower than that. But still there are banks involved in the international lending area that shouldn't be there to the extent they are, at least not without strengthening their management.

The CHAIRMAN. Comptroller Conover, how about some of them that shouldn't be there at all and never should have been, not just more than they should be and the amount of loan risk, but just simply should not have been involved?

Mr. CONOVER. I think it is reasonable to draw that conclusion. I would take the banks that are involved in Mexico, for example, and put them into three groups—the large multinational banks that do business all over the world; the regional banks; and the banks that are located in border States that for years have done business across the border as a natural adjunct to their everyday activities.

It would seem to me that the first group—the multinationals—and the border banks are perhaps best equipped to carry on business with Mexico, and I think probably many regional banks have gone further in their international lending activities than they should have.

The CHAIRMAN. Chairman Volcker, examinations are now conducted annually. What size or type of exposures would precipitate special or more frequent examination?

Mr. VOLCKER. I don't know that we've looked at that from the standpoint of frequency of examination. We do have trigger points in the examination process that escalate the comments that are made and suggest when supervisory action might be taken. I don't think we have anything that systematically leads to more frequent examination. We are proposing more frequent reporting, both so that the public can be better informed and also so that the banks can evaluate their individual positions against the total more frequently, but I'm not aware at this point that we have considered increasing the frequency of examination in any systematic way based upon a particular finding with regard to concentration or and lack of diversification.

The CHAIRMAN. Well, with the rapidity with which the markets change, a year is a long, long time, as we've seen in some of our domestic institutions. Penn Square got in trouble very, very quickly, even though the examination process was going on.

Mr. VOLCKER. I understand your point, and I think it's a reasonable one. We get the data now—some data quarterly and detailed data semiannually—and I would take your point that if that data showed rapid changes in the bank it would raise the question of whether the bank should be approached or comments should be made. I've just been told that that is done now—not necessarily in terms of going back to the formal examination, but in terms of raising questions about the rapidity of change.

The CHAIRMAN. But at this point you have no checkpoints, no systematic way of going about it?

Mr. VOLCKER. To the best of my knowledge, we have no systematic approach on the basis of changes in concentration or volume to go back and conduct another examination. There's no formula to trigger that, to the best of my knowledge.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Volcker, you state on page 8 of your statement, and I quote, "We believe the bank regulatory agencies can use and would plan to use existing authority to implement the program"—that is for foreign lending, and you also say that a rigid or inconsistent legislative approach would be undesirable.

There are several problems with that notion. Congress has no guarantee that reforms will be carried out. In some cases your legal authority may be doubtful. Enforcement would probably be easier with statutory backing. And as I look at this panel here, Mr. Conover will be here for 3 or 4 more years, the bell tolls on you in August. I earnestly hope that you'll be back but we can't count on that. Mr. Isaac has a little longer, but not a great deal longer. So that, as I say, future set of regulators could undo your reforms.

Would you therefore support legislation to implement your program that was not rigid or inconsistent?

Mr. VOLCKER. I would not oppose it.

Senator PROXMIRE. You would not oppose it. Well, that's helpful. May I ask Mr. Conover and Mr. Isaac if you would take the same position?

Mr. CONOVER. Yes, I would support it.

Senator PROXMIRE. Mr. Isaac?

Mr. ISAAC. I would support it.

Senator HEINZ. Two out of three isn't bad.

Senator PROXMIRE. Well, I think "not oppose it" from Mr. Volcker, that's about 2.9.

Mr. VOLCKER. I can understand the case that you made earlier. I think the problem would be with legislation that is unduly rigid or inconsistent.

Senator PROXMIRE. Well, would you provide the committee by the end of the week with a draft bill designed to implement your program so the legislation is neither rigid nor inconsistent?

Mr. VOLCKER. I think we could do that.

Senator PROXMIRE. Very good. May I ask—I'll start with Mr. Isaac and then go right across the table—what were the specific disagreements among the regulators in coming up with the joint memorandum?

Mr. ISAAC. How long do we have?

Senator PROXMIRE. Well, 30 seconds each.

CONTROVERSY OVER RESERVING AREA

Mr. ISAAC. All right. Probably the major area that gave us difficulty was in trying to come up in the reserving area with a workable proposal—trying to define the point at which a country will become reservable and trying to set forth the standards under which we will put countries in different categories. That was probably the area that caused the most amount of controversy.

Senator PROXMIRE. Can you tell me what position you took on that to begin with?

Mr. ISAAC. Well, I think our positions are pretty much in agreement at this point. There's a question in my mind as to whether——

Senator PROXMIRE. My question was, what was your initial position?

Mr. ISAAC. There's a question in my mind as to whether we should be reserving or at least criticizing a loan at an earlier stage than we are in this proposal.

Senator PROXMIRE. So I take it that that was the prime difference that you had, that you felt you should reserve at an earlier time.

Chairman Volcker.

Mr. VOLCKER. Let me say, first of all, Senator, that we've had a lot of discussion on these things, not necessarily because there are philosophical differences but because some of these things are inherently difficult. The fee question is not black or white.

Senator PROXMIRE. I'm sure they are and I don't want to start an argument.

Mr. VOLCKER. I just want to suggest that there are a lot of points of discussion that don't necessarily involve philosophical conflict. I

think the major questions revolve around the particular reserve proposal. I don't know who made the proposal originally, but it's been basically consistent with my view from the start. This same kind of question arises in how we deal with the examination system more generally, or whether there could be other kinds of reserve proposals supplementary to this one. There are pros and cons to that, and we and others have done some work on it. I'm satisfied with the way it is now, but it remains to be worked out. I think we are all of a mind, as you put it, that diversification risk in the international area has to be judged against the capital strength of the institution. How to achieve that balance has been a matter of considerable discussion.

Senator PROXMIRE. Mr. Conover.

Mr. CONOVER. I would say that the reserve proposal was probably the most controversial one as we worked through the specifics of it. But I would say that our objective on that point, what we wanted to accomplish, was pretty clear and we were in agreement on the objective from the outset. On some of the precise details as to how reserves would work there were some differences, but I think we have now worked them out. I do not regard them as being a major problem at all.

We have some considerable amount of work to do on the question of how reserves will be dealt with in examinations and how we will tie in specifically the subject of concentration of risk with some additional capital requirement.

Senator PROXMIRE. Let me tell you first, Mr. Isaac and Mr. Volcker, what my principal problem is with the position you take. The joint memorandum of you three gentlemen says, "The regulators will analyze the bank's capital adequacy in relation to its international loans, when large concentration of credit are in order, the memorandum states, the bank will be "expected" to maintain a higher ratio. The memorandum goes on to say that these higher ratios will become the "recommendations" of the bank regulators.

Why are you proposing only recommended higher ratios and merely expect they will be achieved? Why don't you require higher ratios when needed and enforce compliance? It seems to be a very soft approach here and we may end up with little or nothing?

Mr. VOLCKER. If I may approach that question first, the point at which a supervisory expectation becomes a requirement is maybe a little elusive, but I think it goes to the question of the degree of rigidity or arbitrariness. Achieving that balance is a very difficult question; that's the heart of a lot of the things we have been discussing. I think the use of the word "expectation" is not meant to be unduly soft but rather to leave some room for qualification—based on rate of speed, on particular circumstances that may be involved; I think the thrust is clear.

Let me suggest that the problem goes back a little further. The agencies put out about 18 months ago some capital standards for banks generally, with a degree of numerical quantification that had not been the case before. We did not do it for the largest banks where the capital ratios were the lowest, and I don't remember the exact language, but there was an indication of an expectation that those capital ratios would be raised.

Speaking for myself, I thought that the current ratios were lower than we would want to bless in a numerical standard, but I have always kept an open mind on whether they should be brought into the numerical standard later, after there had been some progress in increasing those ratios. Those ratios have, in fact, gone up pretty consistently in the last couple of years, which I think is a happy development. I can't judge all the reasons for that, but in part I presume it reflects the supervisory concern, and that's perhaps illustrative of both the progress that can be made and the difficulty of setting a numerical standard for this particular purpose when we don't at this point have one for those large banks in general.

Senator PROXMIRE. Mr. Isaac.

ENFORCING CAPITAL STANDARDS

Mr. ISAAC. Well, I believe that we for years have not been aggressive enough in enforcing capital standards in the larger banks. Smaller banks have done quite well over the past decade or more. Until the past few years, the ratios in the larger banks were constantly declining to unacceptably low levels.

Senator PROXMIRE. Isn't it true that every single one of the 10 biggest banks had a capital ratio with respect to its assets of less than 5 percent?

Mr. ISAAC. The top 10? I don't think so.

Mr. VOLCKER. No.

Senator PROXMIRE. Maybe all except one?

Mr. VOLCKER. Not at this point, according to the table I have in front of me anyway. The average primary capital ratio for the top 17 multinationals is 5.02, as we now define it.

Senator PROXMIRE. What's the Bank of America?

Mr. VOLCKER. At the end of last year 4.29.

Senator PROXMIRE. Well, the figures I have are a little earlier than this and that's why there's a difference.

Mr. VOLCKER. They have been coming up. There was significant progress last year for most of these banks.

Mr. ISAAC. The ratios in most of these banks have been rising significantly over the past year or two. Nevertheless, we would like to see the ratios continue to increase in a number of these banks and feel that some fairly strong supervisory action should continue in order to bring that about.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

DIVERSIFY RISKS AND AVOID UNDUE CONCENTRATION

Chairman Volcker, on page 6 you make the laudatory statement that banks should maintain adequate financial strength to deal with unexpected contingencies and be strongly conscious of the need to diversify risks and avoid undue concentration. And I assume, Mr. Isaac and Mr. Conover, you would agree with that.

Now my question is, what is there—I'm going to ask all three of you—in your proposal that will in fact achieve this goal?

Mr. VOLCKER. What in our proposal will achieve that goal?

Senator HEINZ. Yes.

Mr. VOLCKER. Looking at our proposals in their totality they all make some contribution toward that goal.

Senator HEINZ. Well, I can understand how your reserving requirement which will hit Zaire—and we'll get into that in a minute—and your amortization of fees and your disclosure may reduce risks. I understand the reduction of risks, but I don't see how they diversify risks.

Mr. VOLCKER. The part of our proposal that will go most directly to both aspects of this is the strengthening of examination, where we develop specific criteria for diversification and for capital in the light of diversification. Those are not spelled out in the material you have, because frankly it's quite complex to work out the appropriate ratios, to test them, to decide on that appropriate mix of mechanical formula and judgment in applying the ratios. We're hard at work at that and will develop an examination manual or revise the examination manual. We are in the process of doing that precisely to balance these factors, but you don't have the material in front of you, nor do we, in a finished form that develops the formula that attempts to balance this.

Senator HEINZ. What you're saying is that your examiners are going to be more aggressive when they go into the banks?

Mr. VOLCKER. I think that's fair.

Senator HEINZ. And that is your basic mechanism for really bringing about diversification of risks, is that right?

Mr. VOLCKER. I don't know what's more basic; it certainly goes directly to that point.

Senator HEINZ. Of all the things you've proposed, that's the one you're going to rely on the most, is that correct, to diversify?

Mr. VOLCKER. Different people might judge these things differently.

Senator HEINZ. But in your judgment, in Paul Volcker's judgment?

Mr. VOLCKER. I would say yes.

Senator HEINZ. Would you agree, Mr. Isaac?

Mr. ISAAC. I don't think that's going to be terribly effective. I believe disclosure is going to be more effective, coupled with some changes in the current system to make it clear to large depositors and other major funds suppliers that they are not going to be bailed out every time a bank gets in trouble. If I had to pick a single factor that's going to work, it would be disclosure coupled with some more market discipline.

Senator HEINZ. I would agree with you, Mr. Isaac, that better assertiveness training for the bank examiners, if that's possible, is not going to be the solution to this problem. I agree with you that the disclosure that we'll get to in a minute is going to be very helpful indeed. You testified in favor of increased disclosure, as did Mr. Conover, on February 17. Mr. Conover, what are your comments on this? What should we do to bring about the diversification?

Mr. CONOVER. I do not think there is any single one of these five things that necessarily contributes more to the goal of diversification than any other.

Senator HEINZ. Do any of them contribute to diversification significantly?

Mr. CONOVER. Yes, I think they do. I think several of them taken together certainly do.

Senator HEINZ. Which ones?

Mr. CONOVER. I would include the strengthening of the examination process, the additional disclosures, and the prospect of reserves against problem debts.

DISCLOSURE NEEDED

Senator HEINZ. All right. Let's look at those. You've each mentioned them. Let's talk about disclosure. There's certainly no disagreement that we need to disclose. Both Mr. Conover and Mr. Isaac testified in favor of a statutory mandate on disclosure. But as I understand it, your disclosure requirement would be one percent of assets and in the case of many banks that would be, I'm told, around 20 or 25 percent of capital.

Now in the Garn-St Germain bill we had a limitation to any single borrower that's 15 percent of capital. Why shouldn't we set the disclosure at 15 percent. If we thought it was a good enough limit for a single borrower, why shouldn't it be a decent trigger for disclosure internationally?

Mr. VOLCKER. Let me say, first of all, that that limit in the Garn-St Germain bill is 15 percent for unsecured; with certain types of security it can go up to 25 percent.

Senator HEINZ. These are secured loans?

Mr. VOLCKER. Many of them may be secured, but——

Senator HEINZ. What security is there against transfer risk?

Mr. VOLCKER. I was going to say, they are secured in one sense, but it may not be the same kind of security against transfer risk. In most cases, you're dealing with large and strong countries. I'm not sure that it's appropriate to have the same single borrower limits, so to speak, on all the risks in Japan or the United Kingdom as you would have on a single company in the United States.

Senator HEINZ. Well, that's a judgment I guess we're just going to have to make.

What would be the problems with saying 15 percent of capital as opposed to one percent of assets which is roughly 25 percent of capital.

Mr. ISAAC. It's a greater reporting burden on the banks if we lower the threshold level. But I don't have any objection to relating the disclosure to capital rather than total loans. We selected total loans because it's consistent with the current SEC requirement.

Senator HEINZ. So the concept of relating to capital is perfectly sound, is that right?

Mr. VOLCKER. I don't think any of us has any big problem with that, but let me just make one comment. We suggested 1 percent of assets for disclosure of an individual country. We suggested disclosures below that in some combination of exposures, so you would pick up some indication of concentration below the 1 percent of assets.

Senator HEINZ. We expect to see all of that in your bill that you send us.

Mr. ISAAC. Between three-quarters and 1 percent, you disclose the list of the countries involved without showing them individually.

WHAT COUNTRIES WOULD RESERVES APPLY TO NOW?

Senator HEINZ. All right. Let's move to my next concern which is your prudential reserves. What countries would those reserves apply to right now?

Mr. VOLCKER. I'm not sure how much we should be getting into individual countries and commenting upon them, but——

Senator HEINZ. Are there any countries——

Mr. VOLCKER. There are probably four or five around the world that that would clearly apply to now.

Senator HEINZ. Would they apply to Poland?

Mr. VOLCKER. I would think that's possible.

Senator HEINZ. How about Zaire?

Mr. VOLCKER. I hate to list the countries. Zaire has had lots of problems over a period of time.

Senator HEINZ. Well, put it this way, can you think of a country with worse problems than Zaire?

Mr. VOLCKER. It's a reasonable candidate.

Senator HEINZ. Let the record show that the Chairman thought for about 2 hours before——

Mr. VOLCKER. I just don't know whether it's appropriate in a public forum to list all of these countries, some of which may be in the market and some of which may not.

Senator HEINZ. Well, I understand. What we have agreed on there is a very small number of countries that we're unwilling to mention their names and that you will be under enormous pressure to have not five countries on the list but fewer than that, because once the word gets out it's going to be somehow critical.

Mr. VOLCKER. If I may just interject, what we're saying is there are not many countries that have not been able to service their debts over a protracted period of time. I think that's desirable.

Senator HEINZ. Let's take a look at that premise. In theory I think that argument can certainly be made, but of course we're going through a lot of debt restructuring now and my understanding is that you don't go through debt restructuring if there's no need to do it. There's obviously some kind of credit risk and necessity associated here.

HIGHER INTEREST RATES

Now one of the things that's happening with the debt restructuring that's taking place is that much higher fees and interest rates are being charged, such that in some cases the effective interest rate is up the equivalent of four points over the original loan, a combination of fees and additional spread over the life of the loan. On the average, the interest rates are 2 to 3 percent above what they were before. And my understanding is that the banks in these syndications have required higher interest rates in order to stay in the syndication because they believe these loans are riskier. Is that correct?

Mr. VOLCKER. Yes, that's correct, but while I don't have all the rates in front of me, I think you have overestimated the increase in the interest rate.

Senator HEINZ. I'm saying both the fees and the interest rate. The fees disguise the interest rate.

Mr. VOLCKER. The fees can disguise the interest rate, but if you allocate those fees over the length of the loan, as we are proposing in our recommendations, and you take that into account, I think you have, to the best of my knowledge, overestimated the extent of the increase in interest rates. It's certainly significant in some cases.

Senator HEINZ. My time has expired but I just want to try, without getting into the arithmetic, there have been significant increases in fees and in interest rates and I'm going to want, Mr. Chairman, to maybe return for 5 minutes, but in the meantime I would like the regulators to think about the following question, which is, if the banks that are making these loans are asking for higher interest rates and higher fees, that suggests to me that they recognize additional risks involved with these loans. Yet your reserving proposal at no point in time ever, even prospectively down the road, after the present refinancings are worked out and agreed to—at no point does what you propose take into account and recognize in the form of prudential reserves additional levels of risks that the banks themselves, as evidenced by the higher interest rates that they are requiring as well as by the debt restructuring themselves, do recognize. My time has expired. You think about a response. I suspect you will need—a little time might be welcome on that one.

Mr. VOLCKER. I think there is a response, but——

Senator HEINZ. I'm sure you'll have one.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

On the basis of the testimony that I hear here today it's obvious that the Federal regulatory agencies are poised to place new restraints on the international lending practices and I think that's very welcome. As a matter of fact, perhaps overdue.

OBJECT TO LENDING LIMITS OF LOANS TO COUNTRIES

Mr. Chairman Volcker, you've indicated that you're opposed to putting lending limits on various countries. My question to you is, do any other lending countries impose lending limits at the present time and does the IMF object to the placing of these lending limits with regard to loans made to countries?

Mr. VOLCKER. I'm not aware of any general practices of placing rigid limits by individual supervisory authorities. There have been cases—I can think of one country that has an administrative limit or administrative guidance, and has had for some time, on some types of loans, particularly medium term loans. There has been discussion of this I know in some individual countries, but I don't know of a general practice. It's not common, to the best of my knowledge, in supervisory authorities.

Senator SASSER. Mr. Chairman Volcker, if Congress goes ahead and approves the $8.4 billion increase for funding the IMF the For-

eign Relations Committee as I understand it has already authorized, it's expected that the IMF will have to develop some rather severe austerity programs for the countries that receive additional IMF resources, and I was just glancing through your statement here a moment ago and you were indicating that some of the things that would need to be done would be to restrain aggregate domestic demand through reducing Federal deficits, something we can do here at home, and restraining the growth of money and credit. That sounds very familiar here on the domestic level.

But could you detail the elements of the type of austerity program that you might contemplate in Brazil or Mexico or Argentina? And one concern I have about these austerity programs is the impact that it's going to have on the trade with the United States. We're being asked to take a disproportionate share of the burden here in bolstering the IMF and if we institute these very severe austerity programs in these countries that trade extensively with us now and we're very dependent on foreign trade, what is that going to do to our domestic economy?

Let me sharpen the question and say, No. 1, what type of austerity programs are contemplated for these countries; and second, how can we protect our domestic market from taking a disproportionate sacrifice as a result of these austerity programs?

Mr. VOLCKER. The three big countries that you mentioned all have IMF programs at this point and they all do involve fiscal measures. They involve credit ceilings of one type or another or money supply ceilings. They typically involve some understandings with respect to what might broadly be called incomes programs too, wage policies. I think those three elements are common in concept, but obviously they are different country by country. The big problem in these countries—as in the case of the United States, although the proportions are somewhat different—often does revolve around their fiscal problem. Mexico, as I recall the figure, had a deficit last year in proportion to GNP of 16, 17, or 18 percent; I'm not sure that the final figure is yet computed. The IMF program looks to roughly halving that deficit in the course of this year. You have a similar change, proportionately, in the case of Brazil.

All that does have demand effects, and it is going to be reflected and is reflected in the interim period in a reduction in imports in many cases. That's part of the process of restoring an external balance. But in approaching that question I think you have to ask what if there were no IMF assistance? What if there were no additional bank lending? What kind of an adjustment would have been necessary? I think you're forced to answer that in the end the adjustment would be even more severe and certainly less orderly, and the effects on American exports and on the rest of the world economy would be worse.

We are a major exporter to Mexico. We are the primary exporter to Mexico. They are one of our largest markets. Our exports to Mexico dropped at an annual rate of something like $10 billion a year by the fourth quarter of last year, before the IMF program was really in effect, reflecting the existence of those financial strains, reflecting the fact that they didn't have any foreign exchange. They had to cut off imports willy-nilly. The prospects for maintaining imports and, more important, for laying a stronger

base for the economy so that import growth can resume in some kind of an orderly way in coming years, seems to me much greater with the IMF program than without it.

I might make one other point in that connection, because it arose in the committee earlier and I attached an appendix to my statement to deal with the point. Part of these IMF programs, rooted in the articles of agreement of the IMF, is the encouragement of more liberal trading practices on the part of the borrowing countries. When they're in the midst of crisis it's often difficult or impossible to make striking progress in that direction in the short run, but the IMF consistently is concerned with not intensifying existing administrative restraints. It's also consistently concerned with encouraging the borrowing country to liberalize, over a period of time, and to avoid discrimination. In that sense I think the IMF program, certainly as compared to letting events take their course, is very much supportive of an environment in which American exporters can trade freely.

Senator SASSER. If I understand what you're saying, Mr. Chairman, we're in a catch-22 situation here. If we do nothing, according to what you're saying, then the countries deteriorate even further. There's financial chaos and then there's no room for our exports there.

Mr. VOLCKER. True.

Senator SASSER. If we go ahead and bolster up the IMF and try to come forward with some austerity program, that's not going to be helpful to our imports but we're not going to get hurt as badly.

Mr. VOLCKER. That's right. I don't think it's quite catch-22. The choice between those two alternatives seems quite clear.

STRONGER COOPERATION SOUGHT WITH FOREIGN BANK SUPERVISORS

Senator SASSER. Mr. Conover, you stated in your testimony that stronger cooperation should be sought with foreign bank supervisors. Based on your experience so far, how much reliance do you think we could place on cooperation with foreign bank supervisors and how reliable are foreign bank supervisors and have they indicated any willingness to work with us in this matter?

Mr. CONOVER. Senator, there is a mechanism for international cooperation through a subcommittee of the BIS of which I am a member. The Federal Reserve also has representation on that subcommittee and it meets a number of times each year to deal with common supervisory problems. It is a slow process when you are trying to get a number of other countries to go along with you on a common supervisory approach. Nevertheless, the subcommittee has achieved some successes to date. This is an important topic for the subcommittee to deal with.

It was discussed at its last meeting and I think we can look forward to some progress on the subject of a common way of dealing with international lending in the future.

Senator SASSER. Well, how much credence can you give to the information you get from foreign bank supervisors? How reliable is their information?

Mr. CONOVER. Well, the information they give us is reliable. We have no reason to doubt that what they are providing us is accurate. The problem is ——

Senator SASSER. I don't mean that they would deliberately mislead you.

Mr. CONOVER. The problem arises in that they do not always have the same data available on their own banks that they supervise as we do. That is also a topic that gets discussed in those meetings and over time we will make some progress in that area.

I think the thing to remember about the cooperation with foreign bank supervisors is that it is something we need to do. Its benefits will come in the long run because it is a slow process. We will not see dramatic changes in a period of a year or so.

Senator SASSER. One final question, if I may. Mr. Isaac, in the disclosure portion of the regulators' package, it appears to tie in very well with your overall program to expand disclosure of all lending, foreign and domestic, and I read with interest an article you had in either the Wall Street Journal or the New York Times and you were talking about letting market forces work, and I suppose this disclosure aspect of the plan is aimed in that direction, letting market forces work. Is that the case?

Mr. ISAAC. That's correct.

Senator SASSER. What effects do you think this would have, positive and negative?

Mr. ISAAC. I can't think of any negative effects.

Senator SASSER. I can't think of one or two.

Mr. ISAAC. Pardon?

Senator SASSER. I can think of one or two.

Mr. ISAAC. On balance the effects are going to be very positive. If you're talking about disclosure generally, I can give you the arguments people make against disclosure. Some people think it will exacerbate the problems in troubled institutions. We'd like to think it will prevent the problems from arising in the first place or get them cured at an earlier stage should they arise. People have also expressed concerns about the recordkeeping requirements and the like.

On balance, we are very committed to increased disclosure in this area and across the board.

Senator SASSER. Well, my time is up. I'd like to get into that with you in more detail perhaps at another time.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Trible, I wonder if you would allow Senator Heinz just to finish that question he was asking before we turn to you. He was in the middle of it.

Senator HEINZ. It was for Chairman Volcker only. I can come back to the others but I understand Chairman Volcker has to leave around 11.

Chairman Volcker, could you respond to that question?

Mr. VOLCKER. I'll try to reconstruct in my mind what the question was. You are technically correct.

Senator HEINZ. The question in brief was that the banks see them as more riskier and that's why they're asking for more money, yet your reserving requirement doesn't take that into ac-

count. Why shouldn't we ask you to develop a more fine-tuned instrument?

Mr. VOLCKER. Certainly the increase in interest rates or the rescheduling itself does not trigger the reserve requirement. On the interest rate, what you find in the pattern is that they've brought it up substantially in some cases—such as Mexico where the margins were very narrow before. In the Brazilian case, it hasn't gone up very much, if at all. The margins were quite wide there. Maybe it's an appreciation of greater risk in medium-term lending in the rescheduled operations.

But I would argue there's nothing intrinsic in the rescheduling or higher interest rate that necessarily is a trigger for more reserves. These concentrations combined with an evaluation of the riskiness—if that's the right word—of loans to a particular country, do enter into the examination criteria and formulae. They will bear upon the evaluation of a bank and bear upon the capital expectation, if that's the word that we use, the word that Senator Proxmire referred to.

The purpose of this reserving presumably, is to make sure the bank has adequate capital in the broadest sense—protection against risk—including equity capital, including reserves. To the extent the examination process pushes them toward more capital—and the riskiness of the loans and the concentration of the loans would certainly be a factor in that process—you are achieving the general design and goal that you have in mind. It's not done by a mechanical triggering of a reserve position.

LEGISLATIVE MANDATE TO STRUCTURE RESERVING REQUIREMENT

Senator HEINZ. Let me ask you kind of a bottom line question then. How would you feel about a legislative mandate to structure a reserving requirement where the following conditions were present: (1) that there was a substantial restructuring; (2) where a sufficiently higher interest rate was charged such that it was significantly higher than normal market conditions might require; and (3) that the lending institution in question had an unusually high proportion of its banks capital exposed? Now it seems to me that if that isn't the case, where there ought to be some more reserving, there's never going to be a case where there should be more reserving. But I've asked you a question and I shouldn't be trying to convince you.

Mr. VOLCKER. No, I don't think that follows. I can think of much worse cases than what you described, in which case there would be reserving. We did some thinking almost precisely along the lines that you're suggesting, using in part the interest rate criteria as a measure of what the reserves should be. In the end, speaking for myself, I decided that that was an unduly mechanical approach.

I have some concern that we maintain an appropriate balance through the whole program. Yes, we do want to look toward the future and have sufficient encouragement and sufficient incentives toward diversification and certainly toward stronger capital positions. I also recognize we are in a situation right now where the danger is not that the banks are going to multiply their exposures in lending, but that there are incentives—as individual banks per-

ceive it when they don't look at the whole picture—to cut back on lending too far. I think it would be counterproductive to introduce approaches that could reinforce that temptation.

Senator HEINZ. Would you object to a proposal in legislation that would require the Federal Reserve to go further and the regulators—to go further in establishing a reserving proposal that does take into account the kinds of things we've just talked about, but that you would only be obligated to go ahead with such a further reserving requirement at a time when you felt that the safety and soundness of the international banking system or the exposure or the risk of creating an international crisis with respect to one or many countries would not be a concern, that if you were given this explicit flexibility not to go ahead with it until you were satisfied that it would do more good than harm?

Mr. VOLCKER. I'd have to look at the language I suppose, but I would not oppose legislation that gave us more ——

Senator HEINZ. That kind of flexibility?

Mr. VOLCKER [continuing]. More specific authority for reserving. But as it got more detailed as to what would trigger the reserving, I'd have to look at the language very carefully and think it is generally wise to avoid that. If the legislation provided authority, clarified any doubts that such reserving proposals were within our competence to apply when in our judgment it was necessary or desirable, I think that's all right; but I would be very cautious about trying to spell out criteria, which I think is very hard to do in advance.

Senator HEINZ. Just so I understand everybody's answer to Senator Proxmire's question, he asked Chairman Volcker if you would be able to get a draft bill to the committee by Friday and do I understand you correctly that you thought you could do that?

Mr. VOLCKER. Yes; of course, what I had in mind was a draft bill that covered the points that we've covered here. If you introduce a lot of other possibilities, I don't know whether we can do it by Friday.

Senator HEINZ. Do the best you can.

Thank you, Mr. Chairman. I thank Senator Trible.

The CHAIRMAN. Senator Trible.

Senator TRIBLE. Thank you, Mr. Chairman.

Gentlemen, under present projections of international conditions, do you expect the increase in IMF resources to actually be used or are we providing a confidence-builder or backstop to the international finance system?

Mr. VOLCKER. We're certainly doing the latter. I wouldn't expect it to be exhausted, but the present projections suggest the IMF could be pretty fully committed out of its present resources—committed, not used, not disbursed—late this year or early 1984. These things are unpredictable, but given pressures and strains that exist on the system, I would feel distinctly uncomfortable if there were not this backstopping in place by next year. The degree to which it's used is unpredictable.

Senator TRIBLE. Do you other gentlemen agree with that assessment?

[No response.]

COUNTRY LENDING LIMITS REJECTED

Senator TRIBLE. In your joint memorandum you reject the notion of country lending limits. We have limits today on bank exposure to single domestic borrowers. International loans can have all the same risks as domestic ones and then some. If domestic lending limits are warranted, why not international lending limits? Explain to us in more detail your objection to this. You said you're against it, but I would like to know precisely the kind of reasons that argue against it.

Mr. ISAAC. It's difficult to come up with a satisfactory lending limit proposal at this stage. If you were talking 10 years ago, conceivably you could have. Today the banks for the most part are well beyond any limits we would find acceptable.

Second, if you were to set a limit that was rigid, that didn't involve any judgment, then it wouldn't make distinctions among countries the way it ought to. It wouldn't distinguish between a very strong country and a very weak country. If you allow flexibility for people to exercise judgment and put countries in different categories, then the whole process is subjected to a tremendous amount of political pressure.

Finally, I would say that it smacks very much of credit allocation. In the domestic area, we simply say that no one corporation shall borrow more than such and such or no one individual shall borrow more than such and such. We don't say which corporations or which individuals specifically can obtain credit.

In the foreign area, we would actually make the judgment, i.e. the Israelis can obtain so much credit; the Mexicans can borrow so much. If we have flexibility or subjectivity involved in it, we would be deciding how to allocate credit around the world. If we don't have flexibility, if we have rigid controls, it isn't going to work—not very well at least—because it won't distinguish between borrowers.

So we really feel very strongly that the place for these decisions to be made is in the marketplace. For the marketplace to work, one principal element is disclosure. In the past, people haven't known where the banks were loaning their money. Under the proposed new system, they're going to know where the banks are loaning their money. And if they believe the bank is taking too much risk, I presume the bank will be penalized either through not being able to get access to funding or having to pay extra amounts for its funding.

The CHAIRMAN. Senator Trible, if I could interrupt for just a moment, Chairman Volcker, I understand you do have to leave, so we appreciate you coming today and we will carry on with Mr. Conover and Mr. Isaac.

Senator TRIBLE. Mr. Isaac, apropos your last answer, does the solution lie in less regulation or market discipline or more? Specifically, better information on international borrowing and lending and some limit on insuring big depositors against the consequences of banking practices. Do these kind of initiatives provide sufficient remedy in your judgment?

Mr. ISAAC. Different people have different opinions on that because it very much gets into philosophy and your view of the role

of the government and the private sector. We feel very strongly at the FDIC that what we need is substantially more discipline on the part of the marketplace. The factors you mentioned—better disclosure, placing large depositors and creditors of banks on notice that they are at risk—are necessary to foster a strong, stable and prosperous banking system in the future, particularly in a deregulated environment.

We are not opposed to regulation. There's obviously a role, a very important role, that regulation plays in the system; but we think we've relied too heavily on it previously and in the future it isn't going to work if we don't get more marketplace discipline.

Senator TRIBLE. Mr. Conover.

Mr. CONOVER. I think it is a combination in this particular case of some increase in regulation and an increase in market discipline. Neither one does the job by itself but taken together they will do the job.

Senator TRIBLE. And your specific objections to a country lending limits?

Mr. CONOVER. I think the country lending limits poses all kinds of problems. If you establish a single limit, let us say it is a percent of capital. Let us say you established it at 100 percent of capital, probably a level we would both agree would be too high; that would not have caught the Mexicos, Brazils and Argentinas, but it would have caught Japan and the United Kingdom for example. So I think a single lending limit is not going to do the job.

Then think of the alternative. Let us have countries assigned to different lending limits, categories A, B and C. There are two problems with that. One is the process by which you assign countries to the particular categories. It is easy to see that classification getting significantly politicized in the process.

Second, what do you do in that case when a country gets into difficulty? The tendency would be to shift it from one category to a lower category. So, for example, suppose Mexico was in the 75 percent of capital category and suddenly finds itself in difficulty. The natural tendency is to drop it to the next lower category. By doing that, you restrict the banks from participating in the kind of program that they just participated in—that is to say, you keep them from extending the additional $5 billion which they have agreed to extend as part of the program to help Mexico overcome its current difficulties.

So for those reasons, in addition to the one that was mentioned earlier that it is another form of credit allocation, I am opposed to having country lending limits.

Senator TRIBLE. All right. I thank you. I yield back the balance of my time.

The Chairman. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

STRENGTHEN CAPITAL REQUIREMENTS

Mr. Conover, in your statement on page 5, you have "Strengthen Capital Requirements. If a bank decides to carry relatively large concentrations of exposure in a particular country, the regulatory

agencies will expect those banks to maintain a higher level of capital."

Specifically, what is this higher level of capital?

Mr. CONOVER. Specifically, I do not know the answer to the question yet. That is one of the things we have yet to work out amongst ourselves. We are in agreement with the principle that as banks have larger concentrations with a particular country we ought to require that they have additional capital. But whether that requirement should be applied on some kind of a strict formula basis or whether it is to be more judgmental, we have not worked out as yet.

Senator HECHT. Well, basically we've got these loans right now and they're not making payments like any other borrower, so we're restructuring them supposedly at a higher rate of interest, so they're still problem loans.

Mr. Isaac mentioned the market forces at work. You have the power at the FDIC to stop dividends. Would you consider that for these banks at the moment?

Mr. ISAAC. I don't know of any power we have to stop dividends in any of these banks.

Senator HECHT. Well, you can sure recommend it very strongly to the banks that until they have their reserves up to a certain level they should not pay dividends.

Mr. ISAAC. We could take a cease and desist action against a bank if we felt its condition was unsafe and unsound and we could require that its capital be enhanced either through curtailment of dividends or by raising capital, but that's not an easy burden of proof to bear, particularly if it's contested action in a court. I know the Comptroller has recently had experience in that regard and lost a case in court on that subject. The agencies can't go in willy-nilly and tell people they're going to curtail their dividends or increase their capital. We have to have a persuasive case for it under current law.

Senator HECHT. I agree with you, but you can make a very strong case to the president and directors of the bank if you so desire.

One thing about when you stop the dividends, it's a trigger mechanism of our free enterprise system because then the stockholders start asking questions. I know in the Southwest where I live there are many instances where developers have been turned down by banks or had loans called by banks during this period of time that they were trying to develop their own individual State and their local areas and then the banks went and loaned the money in foreign countries and denied people probably far better risks in their own State. But I think it's time the stockholders start asking these questions. I don't think we need an additional tier of regulation. I think you have the right right now to go into these banks, when you have that answer of what is the amount of reserve requirements, and just demand the banks have that. Don't you think we could do that without any other tier of regulation?

Mr. ISAAC. I believe we could do the additional disclosure requirements and the reserving proposal without legislation. I believe we all agree that we would have no objection to legislation. I don't think we meant to argue against additional reserves. What we

were saying is that the legislation is not absolutely necessary—that we could do reserving without it. Personally, I might like to see some of these loans reserved to a greater degree than we're talking about right now.

Senator HECHT. Under our present system, don't you think you have persuasive power to get this done?

Mr. ISAAC. We could get this done if the three agencies were to decide to do it. We would not need to have legislation.

Senator HECHT. I agree with you. How do you feel, Mr. Conover?

Mr. CONOVER. I agree with that. I think we could.

Senator HECHT. Then the next question is why don't you?

Mr. CONOVER. Well, we have suggested we have the appropriate powers to carry out the program that we have proposed. It has, as you know, been suggested by some of your colleagues it might be essential to have some legislation in this regard. We have said that as long as the legislation is broad and consistent with the program we have proposed so that it could be applied under that legislation, we would have no difficulty with it and would support such legislation.

Senator HECHT. The figure that's been around is something like 1,600 banks are engaged in this. Is that the correct figure—in foreign lending in America?

Mr. CONOVER. Something like that, including Mexico.

Senator HECHT. Obviously, every bank is not in the same category, so how can you have legislation to match each one of the 1,600 banks? I think this is more or less an arbitrary decision by the regulators which bank is in more serious trouble and which bank is not. I'm asking you what you expect of the reserve requirements and you're unable to answer that, so what would legislation do on that basis?.

Mr. CONOVER. As far as the reserve requirements are concerned, we would establish reserve requirements under the proposal we have presented for the small number of countries that have experienced protracted payment difficulties. Every bank that is a participant in loans to those countries would be subject to that reserve requirement. So you have uniform treatment across the board, banks large and small.

Senator HECHT. But would you feel you would come forth with what you will specifically propose on these reserve requirements?

Mr. CONOVER. Well, I think we have already specified what we think is appropriate on reserve requirements. In the discussion you and I had a minute ago we were talking about how we tie a requirement for additional capital to increased levels of country exposure on the part of banks. That is something we are actively working on now and should have a solution within the next week or so.

Senator HECHT. Thank you very much.

The CHAIRMAN. Before I turn to Senator Mattingly, I'd like to explain to the remainder of my colleagues here that Governor Partee is perfectly capable of defending the Fed and is able to respond to your questions as well.

Senator MATTINGLY.

PROTECTIONISM

Senator MATTINGLY. Good. I have a question for Mr. Partee. He's a good defender of the Fed. Mr. Volcker has stated that he favored encouraging or favoring more liberal trade practices with the borrowing countries and Senator Sasser had pursued that question with him. However, the IMF was going to require the developing countries to, as they say, import less and export more. Now isn't that protectionism?

Mr. PARTEE. The problem both the IMF and the borrowing country have is to somehow adjust downward the country's need for external finance so that it's borrowing far less.

Senator MATTINGLY. Is that protectionism?

Mr. PARTEE. The only way to do that is to reduce imports.

Senator MATTINGLY. That's not protectionism?

Mr. PARTEE. Not if you do it through domestic strengthening.

Senator MATTINGLY. Mr. Volcker testified it was protectionism at one time before this committee when I asked him that same question.

Mr. PARTEE. I'm not aware of that. I wouldn't call that protectionism. If you did this by restricting imports of a particular kind in particular countries that would be protectionism, but that's not what the IMF has in mind.

Senator MATTINGLY. What liberal trade practices does the Federal Reserve recommend? Are they going to recommend utilization of barriers or subsidies?

Mr. PARTEE. Such recommendations, of course, are made by the IMF not by the Federal Reserve. They would take the form of fiscal restraint in budget deficits, restraint in money and credit expansion, and restraint in wage and other income demands on the economy. Only indirectly would they thereby affect the imports that the country might have made.

Senator MATTINGLY. But the liberal trade practices the IMF would not be encouraging utilization of subsidies?

Mr. PARTEE. No.

Senator MATTINGLY. Nor would they be talking about increasing trade barriers?

Mr. PARTEE. No, that would not be the case. Sometimes you might have a country that has used subsidies and you want them to get away from it, but that would be a gradual business.

Senator MATTINGLY. Like Brazil or a whole laundry list of others if you like. I think it would be helpful for this committee if you would forward a list of those things that you say are trade policies.

Mr. PARTEE. Mr. Mattingly, the appendix in the testimony discusses this very issue.

Senator MATTINGLY. All right. Another question for you, Mr. Partee. Some have suggested that nonperforming loans should be written down. You had failed to include that in any of your recommendations. Would you comment on that?

Mr. PARTEE. I don't think that what we've proposed is in disagreement with that principle. We've said that if a country has protracted difficulty in making interest or principal payments that it's subject to reserve limits, and that is a country that has a nonperforming loan.

Senator MATTINGLY. But that's not a writing down.

Mr. PARTEE. It would take the form of a reserve against current needs that would then be used to reduce net the amount of the asset on the bank's books.

Senator MATTINGLY. Would you object then to a recommendation of recommending they write it down on some of the banks?

Mr. PARTEE. It is an option that we provide in the proposal.

NONPERFORMING LOANS

Senator MATTINGLY. It has not been spelled out clearly.

Mr. PARTEE. It would be an option that would be available to the banks. I think the issue is at what point is a loan considered nonperforming. There I would judge that some of the Senators have a feeling that that point at which loans should be reserved should come more quickly than suggested in the proposal of the regulators.

Senator MATTINGLY. Mr. Conover, would you comment on that writing down of nonperforming loans?

Mr. CONOVER. I think I have to echo Governor Partee's comments that our proposal calls for reserving against foreign loans when they have experienced protracted payment difficulties. In other words, when they are nonperforming.

Senator MATTINGLY. Mr. Partee, Mr. Volcker told Senator Heinz that most countries have at least serviced their debt over a reasonable period of time. If that's the case, why is there such great urgency to increase the IMF funding?

Mr. PARTEE. I think that Mr. Volcker's answer was backward looking, over the last 15 or 20 years. I believe if I understood the exchange at the time, that he pointed out that over the postwar years foreign countries have serviced their debt very well. There have been a few that haven't, and it's only been in the last year that this has loomed as a major issue. Therefore, it's a new risk and a new problem and that's why the IMF and others are turning to the issue at this time.

Senator MATTINGLY. Mr. Isaac, what indicators would precipitate a special examination of a bank's foreign lending activities?

Mr. ISAAC. A special examination on account of foreign lending activity? Is that the question?

Senator MATTINGLY. Is there any standard now for that?

Mr. ISAAC. No, not related specifically to the foreign lending area. We have standards which will cause us to examine a bank more frequently and they have to do with the level of classified assets in the bank, the rate of growth, the funding position—or a change in control of a bank, for example. A number of factors would trigger a more frequent examination, but I don't know anything that I could single out in the foreign lending area that would trigger a special examination as such.

Senator MATTINGLY. Do you think there should be? It would seem to me there should be some sort of criteria before the fact.

Mr. ISAAC. It could do so indirectly today because it may be causing such rapid growth or high asset classifications that it might trigger an examination. I don't know of any that I would say is

unique about the foreign lending area that in and of itself ought to trigger an examination.

Senator MATTINGLY. Aren't there a lot of marginal loans out there?

Mr. ISAAC. Yes,

Senator MATTINGLY. Mr. Conover, you stated in your statement that the international loans carry a degree of risk in addition to traditional commercial credit risk. Does this warrant country lending limits?

Mr. CONOVER. No. I said that there was an additional element called transfer risk that arises when a country may not generate sufficient foreign exchange to service its debts, but I do not think the very existence of that risk warrants the establishment of specific country lending limits.

Senator MATTINGLY. That's all the questions I have, Mr. Chairman.

The CHAIRMAN. I would turn to Senator Heinz to take what time is necessary for him to finish his questions without limiting him to the 10 minute rule, but we will play it by ear.

Senator HEINZ. Thank you, Mr. Chairman. I'll try to be as brief as possible.

Mr. Isaac, when you have banks that have made a lot of loans overseas that have subjected themselves to a great deal of transfer risks which have been forced to go into rescheduling and where the Congress has been forced to underpin the international financial situation with an $8.4 billion increase in the IMF and the GAB general agreement to borrow, does that suggest to you that we should have some greater play of market forces on our banks that go beyond the increased disclosure and a rather modest reserve requirements that the consensus group here has proposed? Does that suggest that to you?

Mr. ISAAC. Yes, it does.

Senator HEINZ. What do you think should be done beyond that and, in addition to the elements of the insuring study that will be forthcoming?

Mr. ISAAC. I think the elements of the insurance study are very important.

Senator HEINZ. I don't mean to discount them, but we don't have them yet.

Mr. ISAAC. That's correct. Beyond that, I would hope that we would have some better accounting generally in this area.

RESERVABILITY OF RESTRUCTURED LOANS?

Senator HEINZ. When you say better accounting, does that mean you would favor different rules as to the reservability of restructured loans?

Mr. ISAAC. Yes. At the very least, I think we need to call a problem loan a problem loan.

Senator HEINZ. If it were up to you—and I realize it's not—what would you like to have seen here?

Mr. ISAAC. I would like to have seen us get loans into these higher risk categories more quickly. Once they fall into the catego-

ry, they should be reserved against or at least subjected to greater criticism.

Senator HEINZ. So that I understand you clearly, could you imagine a categorization of loans—let me turn the question around. What would you use as a trigger to trigger the reservability of such loans? What's presented by the regulators in sum is a lengthy list where the country just about has to be a total unmitigated disaster with absolutely no hope ever of repayment. You favor something a little bit more—the method of dealing with it slightly more in between countries. What should those triggers be?

Mr. ISAAC. I think we mentioned earlier that there were five or six countries reservable under the definitions in the joint memorandum. I can't accept there are only five or six countries in the world against which we ought to be creating reserves. I think we can argue or discuss at some length the specific criteria, as we have been doing over the past month or two, but I would just say they ought to be less rigid, because more than five or 6 countries ought to be reservable.

Senator HEINZ. On page 6 of Comptroller Conover's testimony he recites what's in your joint proposal. He says that reservability could be taken into effect when full interest payments had not been made for six months, the terms of rescheduling agreements had not been met for over one year, the IMF program had not been complied with, and there is no immediate prospect of such compliance or no definite prospects exist for the orderly restoration of debt service. Those are essentially triggers for reservability.

Now have you got any specifics in mind for your trigger for reservability?

Mr. ISAAC. I don't have them before me.

Senator HEINZ. Could you share those with the committee?

Mr. ISAAC. I would be happy to share them. Generally speaking, I don't have any problem with the current proposal in terms of really triggering a significant reserve because when you meet these criteria, you have a very weak creditor on your hands.

Senator HEINZ. I think you're right. I don't think any of us question that these are appropriate for a severe write-down.

Mr. ISAAC. I question whether, when a country is seriously troubled but does not meet all these criteria, can we at least begin the process of requiring reserves at an earlier stage at a lower level?

Senator HEINZ. You're talking about some kind of moderate write-down?

Mr. ISAAC. A moderate reserve created at an earlier stage. Or perhaps, at least criticizing the credit—calling it a problem credit instead of attaching some label to it that doesn't mean anything to anyone—Or, when banks become overly concentrated in specific credits perhaps creating some kind of a diversification reserve requirement. If a bank has more than "x" amount of its capital on loan to a given country maybe, perhaps we should have some kind of concentration reserve requirement. There's got to be ways to instill a little more discipline in this process.

Senator HEINZ. What you're suggesting is there should be a hierarchy of recognition here starting with perhaps a declaration of problem credits going to some kind of moderate reserving and then in the case of the Zaires and Sudans a severe reserving?

Mr. ISAAC. You might start off with criticizing and then go to a moderate reserve and then a more severe reserve.

Senator HEINZ. Now there was not agreement among the regulators on that. What were the objections? Let me ask Mr. Conover. Mr. Conover, did you disagree with Mr. Isaac on that?

Mr. CONOVER. Well, I think the point that reserves might be required earlier is a valid one. However, there is an important consideration to keep in mind. The banks just handed out an additional $5 billion as part of the Mexican package that was a voluntary decision on their part. It was a major part of the overall rescue package in which the U.S. Government, the IMF and the banks participated. If those banks had been faced with the prospect of reserves against that additional extension of credit or if they knew that the additional extension of credit was to be criticized or classified using banking terms, they would have been much more reluctant than they were to participate in that program. As you may know, some of the banks were reluctant to participate.

Senator HEINZ. So I gather what you're saying is you agree with Mr. Isaac in principle, but you could not agree to a mandatory proposal at this time because it would jeopardize restructuring that's in progress.

Mr. CONOVER. Or potential restructuring that might occur in the future. I think we have got to be very careful of the way we structure the definitions of reservables, debt service impaired or liquidity impaired, and the impact that each of those has in terms of the extent to which we criticize in our examination process or the extent to which we require reserves. What we do not want to do, as I said earlier, is cause international lending to come screeching to a halt at a time when it is prudent for some additional lending to continue. In principle, I do not have a problem with the notion that we ought to require reserves earlier. I just say we have got to think it through very carefully.

Senator HEINZ. Suppose we take what I think is a somewhat generous example. Suppose we took 10 years to think it through and said 10 years from today on April 11, 1993, there will be a mandatory reserving requirement that goes into effect along the lines that Mr. Isaac has suggested. Would you think that would be responsible?

Mr. CONOVER. I would think 10 years is probably a sufficiently long timeframe.

Senator HEINZ. So the argument isn't we shouldn't say never; the question is how soon should we do it between now and 1993?

Mr. CONOVER. I think it is a balance.

Senator HEINZ. I see Governor Partee shaking his head.

Mr. CONOVER. I think there is a balancing act that we have got to go through here. On the one hand, things that we want to put in place for international lending supervision we ought to put in place for the long-term view. At the same time, we have got to be careful so that we do not create greater short term problems.

Now if that means we ought to design a supervisory system that has one degree of severity in it now and gradually gets more severe, if that is the right term, over time, then I do not have any problem with that.

Senator HEINZ. All right.

Mr. PARTEE. I would just say that I would hate to see us confuse reserving, which it seems to me is associated with the prospect of uncollectability, and higher capital, which represents a market-type discipline imposed by the regulators. The latter permits concentrations, but presumes that there is a greater risk which ought to be recognized by having more capital. I have no reason to think that the many countries currently having difficulty with their debt service are not going to repay. I think they will. Remember, we are talking about this in a cyclical environment, where we are at the very worst point of the cycle from the standpoint of those countries. As the cycle improves, if those countries take proper disciplinary action, they ought to be able to improve also and to become current in servicing their debt.

Senator HEINZ. When you say repay, by that, do you mean meet the terms of the original loan agreement?

Mr. PARTEE. Not necessarily the original agreement. Many, many domestic borrowers do not meet the terms of the original loan agreement. Their loans are restructured too.

Senator HEINZ. What is the amount of lending currently to Mexico of international lending by U.S. banks to Mexico?

Mr. PARTEE. Total lending is $60 billion and it is over $24 billion for U.S. banks.

Senator HEINZ. Are you saying that you anticipate at some point that that will come down to zero?

Mr. PARTEE. No, no.

Senator HEINZ. Do you anticipate that it's ever going to be less than $20 billion?

Senator PARTEE. No more than I anticipate the United States will pay off its debt.

Senator HEINZ. Exactly my point. You said—you used the term repay and I wasn't quite clear what you meant by it.

Mr. PARTEE. Repay under the terms of the contracts they have.

Senator HEINZ. The renegotiated contracts?

Mr. PARTEE. In time, with improved earnings and improved exports, the capital markets will open to these countries and it will be quite possible to find new lenders to replace old lenders who are being repaid according to the terms of their loans.

Senator HEINZ. Now I understand what you mean. Let me ask you about capital adequacy which is something that I know the Fed cares about a good deal. Are you authorized by law to use any sanctions to enforce standards for higher capital ratios with recalcitrant banks?

Mr. PARTEE. As Chairman Isaac said earlier, if the capital is so low that it endangers the safety and soundness of the bank, we can take legal action, cease-and-desist action, against the bank. The other area in which it might apply in our case is, I think, in the handling of applications for new activities. One presumes strength on the part of the applicant who wishes to take on the new activity, financial strength, and we might find insufficient financial strength because of low capital.

Senator HEINZ. Well, let me--I don't know if this was exactly my question, but let me put it this way. Many of the money center banks have had low capital ratios and if you went back 2 years they might not have been such as to undermine the safety and

soundness of the bank. The banks might not have been judged near collapse, but suppose one of them had said to you, no, we think that 3 percent is adequate capital. By law, what authority would you have to say, no, we disagree, if you don't go up to *x* percent over the next 3 or 4 years by issuing preferred stock and common stock, we have the authority to do *x* to you. What authority do you have to do *x* and what is *x* in that circumstance?

Mr. PARTEE. That authority resides with the chartering agency much more than anyone else. I would think in the Comptroller's case he can take action. In our case what we could do if the capital was quite low would be to refuse to entertain that application for new activity.

Senator HEINZ. Just for the new activity?

Mr. PARTEE. Right.

ENDORSE CONCEPT OF SPREADING FEES

Senator HEINZ. Let me ask all of you this last question. You have all endorsed the concept of spreading fees but there's something that troubles me about your proposal with respect to fees. I'm not troubled by the fact you want to take that portion of fee or syndication income that represents the coverage of expenses into current income. That obviously makes sense. However, that doesn't tell anybody how it is you're going to spread the fee over the life of the loan. The reason that's a problem is that some of these loans are written as 90-day loans, even though they are written that way with the prospect of renewal. While it's well and good to say what can be counted in current income, what are the ground rules going to be on spreading these fees? And the reason it is important is that there is a fair amount of evidence, given to this committee, that one of the reasons that banks kind of continue to lend internationally beyond the level of commonsense is that many international loan departments or loan officers were under pressure to keep bank earnings up through earning syndication fees and those fees were taken as income quarterly. Ninety days is quarterly or is the equivalent of quarterly. So if the net result of your proposal was just to permit 90-day loans to be written and fees to be taken over that 90-day period, it's no improvement.

Let me ask Mr. Conover how do you intend to improve or deal with that problem?

Mr. CONOVER. I would agree with you that if short-term spreading of fees was the way it worked out, there would be no improvement. However, that is not the intent.

Senator HEINZ. I understand your intent and I salute your intent. The question is, practically speaking, what are you going to do?

Mr. CONOVER. I suspect what we will have to do is look at the actual practice that occurs with the loans. We would ask the banks to tell us what they expect the life of that loan to be and to insure that they take the fees into income over the true life of the loan rather than the 90-day life that gets rolled over forever and ever and ever.

Senator HEINZ. You're going to ask the bank how long they're really committed in a foreign country?

Mr. CONOVER. I am not sure of any other way to approach it.

Senator HEINZ. They will say well this is a 90-day loan just like any of our other 90-day loans.

Mr. CONOVER. Fine. Then let us have it paid off in 90 days.

Senator HEINZ. That's why you don't like country risk limits. I think it's fine for you to say that but I don't think you can really do that, can you?

Mr. PARTEE. I don't really think the problem will be that difficult for syndicated loans. The restructured loans are for specific periods. The project loans within the country are usually long term. The only loans that are quite short are the trade loans for imports and exports and in fact, they do ordinarily liquidate within that length of time. If, however, in an effort to get around this rule, the banks were to write 90-day loans with rollover agreements, we would look through that and count the whole time as the life of the loan.

Senator HEINZ. The Heinz-Proxmire bill, S. 502, doesn't compel you to set rigid limits across the board for country risk limits and then openly announce them. Why does a country lending limit have to be so public and inflexible as to cause the problems that you say it would cause?

Mr. PARTEE. That's our concern. Our experience has been that if it is a subjective limit, which was spoken of as an alternative, then it will soon become publicly known that, subjectively, the regulators have determined that country A is subject to this class of loan; it will become known because the banks, after all, are responsive to the regulators, and that can bring, and has brought in the past, very substantial political pressure to bear on the agencies through international diplomatic channels. It can be very difficult for professional examiners to handle this and to be subjected to that kind of pressure.

Senator HEINZ. Are you under pressure today to keep countries out of the lowest of the three categories in your two by three matrix, the weak, the strong, and whatever the middle term is?

Mr. PARTEE. The categories are not known; categorizing occurs in terms of when you touch off a concentration comment, and that was drawn up precisely in order to try to keep the information from becoming public.

Senator HEINZ. But isn't the purpose of that matrix to jawbone banks into observing what is in effect a de facto country risk limit?

Mr. PARTEE. It's not country risk; it's really a concentration risk.

Senator HEINZ. Well, you call it concentration. I call it limitation. There's a limit beyond which something that was prudent becomes a concentration. The only difference is you call that a boundary; I call it a limit; and there is a distinction. It is different but nonetheless there is a line that you're unhappy about when banks cross it, is that not correct?

Mr. PARTEE. Yes; and it's drawn in terms of different proportions of capital. It just calls for comment on concentration. It may be that we would have no difficulty if it had more teeth in it.

Mr. ISAAC. I would just say that I don't think there's been much pressure in terms of strong, moderately strong, or weak classifications. If you wind up in one of those categories then it really doesn't matter. When you do get some teeth in it, is when you get

to substandard, doubtful, or loss. There is a lot of pressure to keep countries out of those categories because if you fall in there, something happens. If we have country lending limits that have teeth in them, I believe you will have tremendous pressures on the process to keep those limits as high as possible for various countries.

Senator HEINZ. Well, personally, I think a good reserving requirement is preferable to lending limits, but at the present time I've got to say I'm not enamored with the consensus proposal for reserving, at least as it stands right now.

Mr. Chairman, thank you very much.

THERE WILL BE LEGISLATION

The CHAIRMAN. Thank you. Gentlemen, I appreciate your attendance here today. We will have additional questions I'm sure from other members of the committee for your response in writing. But let me bring the hearing to the bottom line. No matter how sincere you are with your memorandum, and I do not doubt your sincerity, that legislation is not needed and you can handle it administratively, believe me, there will be legislation.

Senator Proxmire asked Chairman Volcker if he could have it by Friday. There was some additional requests. Senator Heinz said to do the best you can.

I also suggest that you do the best you can, even though I may agree with you that legislation may not be necessary. The price of $8.4 billion increase in the Congress is going to be legislation, even if all we did was put your memorandum into legislative language, the bottom line politically is that Congress is not going to approve that $8.4 billion unless their stamp is on it so they can go home and say we didn't bail out those big banks and we're helping international trade and all that, but we are making sure that they don't do it again.

So I want to be very blunt and very candid with you, do the best you can as rapidly as you can for a legislative proposal because your memorandum, no matter how well intended will not sell in Congress. There will be legislation attached to that $8.4 billion. It doesn't take much political sixth sense or expertise to determine that after the last few months of being involved in this problem. So, let's face the realities of the situation and get us the legislative proposal up here on which we can make some comparisons and, as I said initially, hopefully come up with a well balanced legislative proposal without overreacting to the problem.

Senator Heinz, do you wish to say something?

Senator HEINZ. Well, Mr. Chairman, I commend you for your statement, as I earlier congratulated you on this hearing. My observation is that two of the three regulators, Mr. Isaac and Mr. Conover, have said for the record that they feel some kind of legislation is necessary and it's only the Federal Reserve that has maintained that no legislation is necessary. And I just wanted to see if your understanding of that was different from mine. But, Mr. Conover and Mr. Isaac each said something is needed legislatively with respect to disclosure and a number of other things. It's only the Fed that says we're doing enough of a good job that nothing is necessary and I won't comment further on that.

Mr. CONOVER. I believe we said—at least I said—if you feel that legislation is necessary, we will support it and work with you to shape it.

Senator HEINZ. Well, on February 17, you endorsed legislation on disclosure.

Mr. CONOVER. Yes; I did.

The Chairman. It was my understanding that at least on some parts both of you on February 17 and in your testimony today, not in a blanket approval but at least been unwilling to oppose, as Chairman Volcker said, certain things. Well, I just wanted to sort out all the wheat and chaff and say that legislation is forthcoming so we accept your willingness to work with us on shaping that legislation that will be attached to the $8.4 billion increase. Thank you very much.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Bills being considered follow:]

II

98TH CONGRESS
1ST SESSION

S. 502

To amend the Federal Reserve Act to authorize limits on loans to foreign countries, and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 16 (legislative day, FEBRUARY 14), 1983

Mr. HEINZ (for himself and Mr. PROXMIRE) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Federal Reserve Act to authorize limits on loans to foreign countries, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "International Lending Reform Act of 1983".

SEC. 2. The Federal Reserve Act is amended by adding at the end thereof the following:

"COUNTRY LENDING LIMITS

"SEC. 32. (a) The aggregate amount of outstanding extensions of credit by an insured bank to public and private borrowers in a foreign country may not exceed the amount

permitted under regulations prescribed by the Board under this section.

"(b) Regulations of the Board under this section—

"(1) shall specify the maximum permissible amount of extensions of credit outstanding as a percentage of an insured bank's capital, as defined by the Board; and

"(2) shall provide for different percentage limitations for specific countries on the basis of such factors as the Board determines are indicative of the ability of public and private borrowers in those countries to repay such extensions of credit.

"(c) Any insured bank which is not in compliance with the Board's regulations under this section shall submit to the Board a plan for achieving compliance. The Board shall not approve any such plan unless it determines that the insured bank is making a satisfactory effort to achieve compliance by the earliest practical date.

"(d) The Board, upon notification to the House Committee on Banking, Finance and Urban Affairs, and the Senate Committee on Banking, Housing, and Urban Affairs, may waive the provisions of this section with respect to any country for one period of not to exceed one year if the Board determines that a waiver is essential to prevent a serious threat to the stability of the international monetary system.

Any waiver made under this section with respect to any country may not be made again with respect to that country until one year has elapsed since the expiration of the last waiver unless the Congress, by concurrent resolution, indicates it has no objection to an earlier renewal of such waiver.

"(e) For the purpose of this section and sections 33 and 34—

"(1) all of the powers and authorities available to the Board with respect to member banks under section 8 of the Federal Deposit Insurance Act and section 29 of this Act shall be available to enforce compliance with the provisions of this section and sections 33 and 34 and the regulations under this section and sections 33 and 34 with respect to insured banks;

"(2) the term 'insured bank' has the same meaning given by section 3 of the Federal Deposit Insurance Act; and

"(3) the Board shall publish regulations not later than ninety days following the date of enactment of this section.

"LOAN LOSS RESERVES

"SEC. 33. Whenever the Board determines that the aggregate amount of external debt incurred by the public and private borrowers in a foreign country is at a level where there is a substantial likelihood that such debt cannot reason-

ably be expected to be repaid in accordance with its original terms and conditions without additional borrowing or a major restructuring of that debt, the Board shall, by regulation, require each insured bank to establish a loan loss reserve against the total amount of credit extended by that bank to public and private borrowers in that country. The amount of the reserve shall be indicative, in the judgment of the Board, of the degree of difficulty expected to be encountered by the public and private borrowers in that country in repaying external debt. Such a loan loss reserve shall be separately maintained and deducted from the bank's statement of assets and shall not be considered as part of its capital for regulatory or disclosure purposes.

"LOAN FEES

"SEC. 34. The Board shall, by regulation, require that all fees charged by any insured bank in connection with any loan or loan restructuring in excess of $1,000,000 shall be amortized over the life of the loan to the extent that such fees represent interest and not administrative expenses related to such loan or loan restructuring. Income for regulatory or disclosure purposes in excess of the amount permitted under regulations promulgated pursuant to this section shall not be reported by any insured banks.".

II

98TH CONGRESS
1ST SESSION

S. 695

To amend the Bretton Woods Agreements Act to authorize consent to and authorize appropriations for an increase in the United States quota in the International Monetary Fund and to authorize appropriations for increased United States participation in the IMF's General Arrangements to Borrow.

IN THE SENATE OF THE UNITED STATES

MARCH 7, 1983

Mr. PERCY (by request) introduced the following bill; which was read twice and referred to the Committee on Foreign Relations

MARCH 11 (legislative day, MARCH 7), 1983

Ordered, that when reported, the bill be referred to the Committee on Banking, Housing, and Urban Affairs

MARCH 24 (legislative day, MARCH 21), 1983

Reported by Mr. PERCY, from the Committee on Foreign Relations, with an amendment

[Strike out all after the enacting clause and insert the part printed in italic]

APRIL 5, 1983

Referred to the Committee on Banking, Housing, and Urban Affairs pursuant to the order of March 11, 1983

A BILL

To amend the Bretton Woods Agreements Act to authorize consent to and authorize appropriations for an increase in the United States quota in the International Monetary Fund and to authorize appropriations for increased United States participation in the IMF's General Arrangements to Borrow.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, ~~That the Bretton Wood Agreements Act (22 U.S.C. 286 et seq.) is amended by:~~

~~(a) adding at the end thereof the following new section:~~

~~"SEC. 40. The United States Governor of the Fund is authorized to consent to an increase in the quota of the United States in the Fund equivalent to 5,310.8 million Special Drawing Rights, limited to such amounts as are appropriated in advance in appropriation Acts."~~

~~(b) in section 17 subsection (a)—~~

~~(1) inserting "as amended in accordance with its terms," after "1962;" and~~

~~(2) deleting "$2,000,000,000" and inserting "4,250 million Special Drawing Rights, limited to such amounts as are appropriated in advance in appropriation Acts," in lieu thereof;~~

~~(c) in section 17, subsection (b), deleting "$2,000,000,000" and inserting "4,250 million Special Drawing Rights" in lieu thereof.~~

That (a) section 17 of the Bretton Woods Agreements Act (22 U.S.C. 286e-2) is amended—

(1) by striking out in subsection (a) "decision of January 5, 1962" and inserting in lieu thereof "deci-

sions of January 5, 1962, and February 24, 1983, as amended in accordance with their terms,";

(2) by striking out in subsection (a) "not to exceed $2,000,000,000 outstanding at any one time," and inserting in lieu thereof "in an amount not to exceed the equivalent of 4,250 million Special Drawing Rights, limited to such amounts as are appropriated in advance in appropriation Acts,";

(3) by striking out in subsection (b) "$2,000,000,000" and inserting in lieu thereof "an amount equivalent to 4,250 million Special Drawing Rights"; and

(4) by adding at the end thereof the following:

"(d) Unless the Congress by law so authorizes, the President, the Secretary of the Treasury, or any other person acting on behalf of the United States, may not instruct the United States Executive Director to the Fund to consent to any amendment to the Decision of February 24, 1983, of the Executive Directors of the Fund if the adoption of such amendment would significantly alter the amount, terms, or conditions of participation by the United States in the General Arrangements to Borrow.".

(b) The Bretton Woods Agreements Act (22 U.S.C. 286 et seq.) is amended by adding at the end thereof the following new sections:

"SEC. 40. The United States Governor of the Fund is authorized to consent to an increase in the quota of the United States in the Fund equivalent to 5,310.8 million Special Drawing Rights, limited to such amounts as are appropriated in advance in appropriation Acts.

"SEC. 41. (a) It is the sense of the Congress that—

"(1) the lack of sufficient information currently available to allow members of the Fund to make sound and prudent decisions concerning their public and private sector international borrowing, and to allow lenders to make sound and prudent decisions concerning their international lending, threatens the stability of the international monetary system; and

"(2) in recognition of the Fund's duties, as provided particularly by article VIII of the Articles of Agreement of the Fund, to act as a center for the collection and exchange of information on monetary and financial problems, the Fund should adopt necessary and appropriate measures to ensure that more complete and timely financial information will be available.

"(b) To this end, the Secretary of the Treasury shall instruct the United States Executive Director to the Fund to initiate discussions with other directors of the Fund and with Fund management, and to propose and vote for, the adoption of procedures, within the Fund—

"(1) to collect and disseminate information, on a quarterly basis, from and to Fund members, and to any other persons as the Fund deems appropriate, concerning—

"(A) the extension of credit by banks or nonbanks to private and public entities, including all government entities, instrumentalities, and central banks of member countries; and

"(B) the receipt of such credit by those private and public entities of member countries, where such banks or nonbanks are not principally established within the borders of the member country to which the credits are extended;

"(2) to review and comment, on a timely basis, on such contemplated receipt of credit by any member as the Fund determines to be of significant monetary value given the current state and size of that member's economy; and

"(3) to disseminate publicly information which is developed in the course of the Fund's collection, review, and comment efforts and which the Fund determines would serve to enhance the informational base upon which international borrowing and lending decisions are taken.

"(c) As used in this section, the term 'credit' includes—

"(1) outstanding loans to private and public entities, including government entities, instrumentalities, and central banks of any member, and

"(2) unused lines of credit which have been made available to those private and public entities of any member,

where such loans or lines of credit are repayable in freely convertible currency.

"(d) The President is authorized to use the authority provided under section 8 of this Act to require any person (as defined by that section) subject to the jurisdiction of the United States to provide such information as the Fund determines to be necessary in order to carry out the provisions of this section.

"(e) Within six months after the date of enactment of this section, the Secretary of the Treasury shall prepare and transmit to the Committee on Foreign Relations and the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives, a report on the progress made toward establishing collection, review, comment, and reporting procedures within the Fund, as provided by this section.

"SEC. 42. It is the sense of Congress that the Chairman of the Federal Reserve, the Secretary of the Treasury,

and the Secretary of State should consider United States membership in the Bank for International Settlements and report to Congress within ninety days of the enactment of this legislation on their findings.".

NATIONAL FOREIGN TRADE COUNCIL, INC.

100 EAST 42ND STREET, NEW YORK, N.Y. 10017 (212) 867-5630

April 20, 1983

MEMORANDUM ON IMF QUOTAS

The National Foreign Trade Council, a private, non-profit organization of 650 U.S. companies engaged in international trade and investment, supports the Administration's proposal for an increase in the U.S. contribution to the International Monetary Fund's basic quotas and the IMF's General Arrangement to Borrow.

We believe the increases will help to strengthen the international monetary system during a difficult period of adjustment, and to preserve the purchasing power of developing countries. In both respects, the effect will be to foster the much-needed expansion of American exports and export-related employment.

Developing countries, a fast-growing market for U.S. products, now account for 39 percent of U.S. merchandise exports. Some of the major developing countries have become the victims of large debt levels and high interest rates in a time of falling income. While, with the assistance of the IMF, many have been able to retain the confidence of lenders, the international financial system has been threatened at times by the difficulty of rescheduling both private and public debt. So great is this problem that the resources of the IMF as lender of last resort must be expanded if creditors are to be assured that developing countries will continue to be reasonable risks. Any wholesale failure to reschedule existing debt and to withdraw from new lending can have a serious effect on U.S. exports to this important sector of the world market.

In the short run, austerity programs to deal with debt burdens will impair prospects for U.S. exports to these countries, but a balance must be struck on the long-term need for strengthening the international financial system on which the growth of world trade depends. The possibility of major defaults by borrowing nations threatens the long-term stability of the system. As Secretary Donald T. Regan has testified, "Such a development would have substantially negative consequences in terms of economic activity, jobs, production, and domestic financial stability."

A coordinated worldwide effort is needed to forestall any such possibility. The United States should continue to support efforts of the International Monetary Fund to assist developing nations confronted with declining reserves and difficult balance of payments problems. IMF assistance should continue to be conditioned on the adoption of appropriate adjustment policies. The cooperation of governments and of the international banking community will also be important in a multilateral effort to bridge current weaknesses in the structure of Third World debt and to provide necessary resources for the continuing financing of world trade and economic development.

However, we question the desirability of proposals for imposing unrealistic and impractical limitations on bank loans to foreign countries--for example, legislation which would impose country lending limits and require special loan loss reserves. These limitations could diminish the amount of credit available to U.S. exporters and increase the price of those funds at the same time. They could well have a negative effect on the global recovery so necessary to the resolution of the debt problem. This in turn would make default by developing countries, and failure of some lending institutions, more likely--with an attendant loss of faith in the financial system. Among the losers would be American exporters.

We recommend that the Congress approve the Administration's request for authority to participate in the IMF quota increase and that it not impose unrealistic restrictions on the commercial banks which will share in providing substantial resources to extricate the international monetary system from the present dilemma of Third World debt.

Richard W. Roberts
President

RWR:pe

AMERICAN INSURANCE ASSOCIATION
85 JOHN STREET
NEW YORK, N.Y. 10038
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March 3, 1983

The Honorable John Heinz
Senate Banking Committee
Washington, D.C. 20510

Attention: Mr. Paul Freedenberg

Dear Senator Heinz:

On behalf of the American Insurance Association, a trade association representing 165 property-casualty insurance companies, I would like to submit the enclosed statement for the record in the Senate Banking Committee's hearing on providing greater resources to the International Monetary Fund.

Although AIA was unable to testify at the recent hearing, a number of our member companies do business on an international basis and view the present liquidity problem facing many of the developing nations with an extreme sense of urgency. We would be pleased to discuss the statement at the Committee's convenience.

Thank you for your cooperation.

Sincerely,

T. Lawrence Jones

T. Lawrence Jones
President

TLJ:ss
Enclosure

WILLIAM O. BAILEY, CHAIRMAN PETER LARDNER, VICE CHAIRMAN EDWARD H. BUDD, VICE CHAIRMAN T. LAWRENCE JONES, PRESIDENT

STATEMENT OF

AMERICAN INSURANCE ASSOCIATION

The American Insurance Association is pleased to have the opportunity to present its views on the current international financial problems and the most appropriate measures to deal with them.

American Insurance Association recommends that the International Monetary Fund (IMF) be used to help provide countries with severe liquidity problems emergency funding. In order to accomplish this, however, the IMF will have to be provided with additional resources.

The IMF funding will not solve the problem, but it may help to attract additional capital from private sources. In that sense, the Congress should not view this solution as a bailing out of the banks. The banks will need to stay in and help solve the problem. In fact, the Congress may even wish to obtain the assurance of the international banking community that additional amounts of capital will be made available.

American Insurance Association believes that the problems faced by lending as well as borrowing nations are not insurmountable. The solutions are not simple and will require the discipline of both lenders and borrowers. We must, however, recognize that to ignore the problem will in the long-run create even greater problems.

As Mr. A. W. Clausen, President of the World Bank, recently observed, "one quarter of everything produced in the world is not traded across national borders." This trading plays an increasingly larger role in the stability and

growth of other domestic financial institutions such as the casualty insurance industry. The efforts to deal with the strains on the international financial system will, therefore, require the cooperation of borrowing countries and lenders, coordinated by the International Monetary Fund (IMF).

In the long-term, however, more will be required than IMF "bridge" loans. As a first step toward the long-term, the various bank regulatory agencies should re-evaluate the current approach toward supervision. One approach in this re-evaluation should be the role that disclosure can play in promoting discipline.

Recently, the Securities and Exchange Commission broadened its disclosure requirements for bank holding companies where loans are outstanding in countries experiencing liquidity problems. It may be appropriate to extend this requirement to all foreign lending on an individual country-by-country basis. This disclosure requirement may help to rectify the problem bankers found themselves in the last year.

There are obviously other ways to deal with the regulators gap in knowledge of foreign lending practices. An examination of current accounting and reserving practices could, perhaps, help to promote more uniform practices.

Although it serves no useful purpose to attempt to place blame on any one particular group or circumstance for the international financial condition, it is fair to say that a combination of factors stemming from the large oil price increases by OPEC during the early and mid 1970s and the efforts by the large multinational banks to recycle "petro-dollars" back to the non-exporting developing countries in the form of loans set the stage for the present economic and financial problems these countries are now faced with. As is often the case, too much of a good thing (in this case, easy loans) resulted in unforeseen problems.

The high oil prices, however, do not provide a satisfactory explanation for the debts of the oil exporting nations; indeed, some of the most indebted countries are oil exporters. The explanation in these cases, Mexico for example, is that their economies expanded at a more rapid rate than could be accommodated by the increase in revenues. As such, the expansion was accompanied by large budget deficits and high rates of inflation.

The rapid expansion of international bank lending created enormous debts for the developing countries. As of June 1982, banks were owed $270 billion from both public and private sector borrowers. The share of total claims owed to U. S. banks by developing countries was approximately $99 billion.

Despite the rapid increase in debt, it was generally felt by banks in the U. S. and elsewhere that the economics of these countries would continue to expand, and thus the debt service payments were manageable. In fact, that view was reinforced by the rapid increase in inflation which kept real interest rates low by comparison.

The regulators of banking institutions involved in the international lending can also be faulted by failing to keep abreast of this foreign lending activity and for not taking appropriate steps to ensure that the safety and soundness of those institutions were not compromised. Available information, moreover, concerning the financial conditions of these foreign nations was not available and not required for these loans. There is also no question, however, that banks saw opportunities to make very profitable loans to foreign governments and large business firms with little or no concomitant risk.

The combination of these factors created the environment in which potential financial difficulties became reality as soon as the world economy entered the present period of little or no economic growth. As the world recession limited the growth of trading markets and reversed the trend of constantly increasing

prices for materials shipped from developing countries, non-oil-exporting countries found themselves in a situation where the debt service payments remained constant while the foundation of growth upon which the debt was built began to crumble.

In addition to the worldwide recession, two other contributing factors were the record high interest rates, which exacerbated the problem because a significant share of the lending was done on a floating-rate basis, and the appreciation of the dollar, which increased the debt burden for dollar denominated debt.

Conclusion

American Insurance Association believes the supervisory role should be left to the bank regulators. A mandate from the Congess to those regulators should help regulators to focus on the problem of not having accurate information regarding the exposure banks have. We do, however, believe it is urgent that the Congress act immediately to make the resources available to the IMF in order to provide the short-term response called for.

Failure to deal effectively with the immediate international financial crisis could be harmful not only to the international financial system. It could also jeopardize the financial markets in our own country, which in turn would severely damage the recovery of our economy.

CITIBANK

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George J. Clark
Executive Vice President

May 5, 1983

The Honorable William Proxmire,
Subcommittee on International Finance
and Monetary Policy
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

I am pleased to provide my comments in response to your questions as transmitted in a letter dated March 11, 1983 from Senator Heinz. I recognize that we have been in touch with the Congress in the meantime on more specific legislative proposals in some detail, but hope that the attached observations will still be of use to you as background on these important issues.

Very truly yours,

cc: The Honorable John Heinz, Chairman
Subcommittee on International Finance and Monetary Policy

1. When domestic credits are weak, bank examiners classify loans as substandard, doubtful or loss and loans are required to be written down. I understand that the regulators are reluctant to classify countries as loss. Would it not make good sense for the Federal Reserve to have the authority to require reserves to be set aside by banking institutions to reflect the risk in international lending that are problems?

The regulators' reluctance to "classify countries as loss" reflects historical experience. It recognizes that, while countries may go through periods of foreign exchange stringencies and thus have temporary problems servicing their external debt, the record shows that they ultimately make the needed adjustments in their policies and management, and regain their foreign exchange earning capacity, enabling them to resume debt servicing and attract needed new capital. I believe the regulators are correct in recognizing that, while individual credits abroad often deserve classification as loss, classifying countries as loss not only ignores this historical record but also risks creating disincentives for banks to continue responsible and vitally needed lending to countries going through balance of payments adjustment programs.

2. According to the Federal Reserve, the nine largest U.S. banks have outstanding loans to Mexico, Argentina and Brazil in an amount equal to 112.5 percent of their capital. Do you agree that there is a risk that can be described as a country risk? If so, should not the Federal Reserve have the authority to write regulations governing concentrations of credit to reflect country risk?

I certainly agree that "country risk" is a significant factor in responsible lending, and Citibank uses considerable resources to analyze and manage such risk in our portfolio. For some time, the regulators have also discussed with us the various risks specific to lending to borrower within given countries, and those discussions have been helpful to both parties. As to specific regulations, I would have to see the specific language to comment on them; my basic concern would be that no regulations be cast in concrete which would cause a significant number of banks to reduce responsible, international lending activity at a time when the continued availability of capital to the LDC's is important.

3. Recent press reports reveal that in connection with restructuring loans to countries that cannot be paid as originally contracted for the bank derives large up front fees that are taken into the income account in the first year. Thus at a time when the loan portfolio may be weaker the banks income appears to be increasing. Should not the Federal Reserve adopt a rule requiring such fees to be amortized over the remaining life of the loan?

I agree, and Citibank already amortizes such fees over the life of the loan, when consistent with sound accounting principles. (Some fees, of course, such as commitment fees, bear no relation to the actual loan, but are rather a fee paid to keep a line of credit open to a prospective borrower. Such fees cannot be amortized over the life of the "loan".) However, your question implies that restructuring, per se, suggests a weaker portfolio. In fact restructured loans, normally in the context of an IMF program, are often stronger rather than weaker loans.

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